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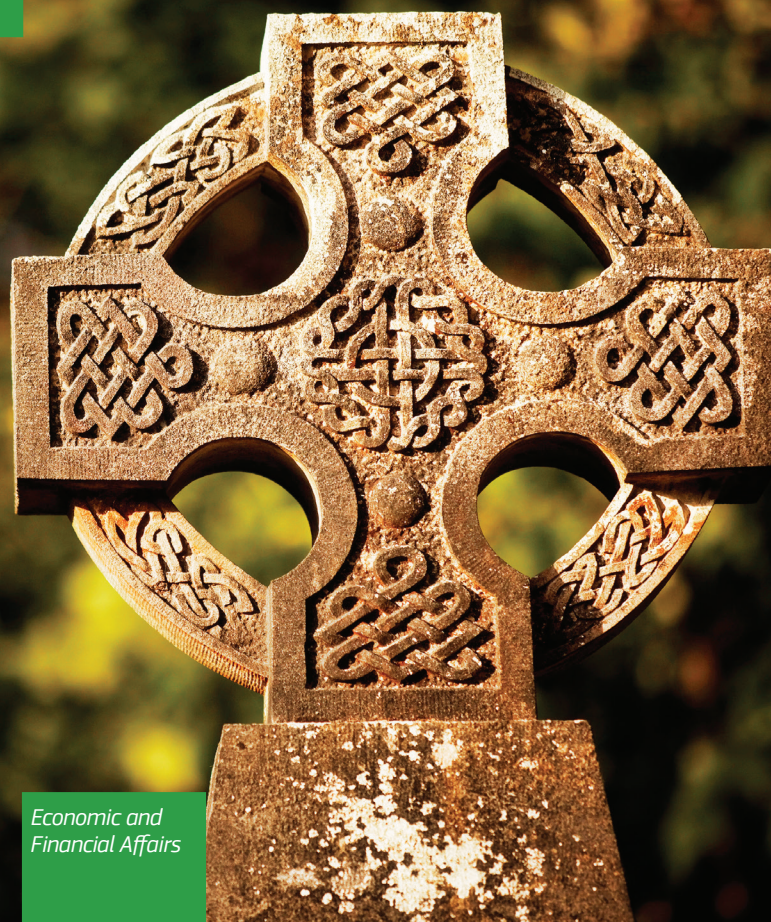
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Post-Programme Surveillance Report

Ireland, Spring 2017

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European Commission

Directorate-General for Economic and Financial Affairs

Post-Programme Surveillance Report

Ireland, Spring 2017

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The report reflects information available up until 8 June 2017.

ABBREVIATIONS

AIB	Allied Irish Bank	INBS	Irish Nationwide Building Society
BEPS	Base Erosion and Profit Shifting	ISIF	Ireland Strategic Investment Fund
BOI	Bank of Ireland	KfW	Kreditanstalt für Wiederaufbau (German State Development Bank)
CBI	Central Bank of Ireland	MIP	Macroeconomic imbalance procedure
COSME	EU programme for the Competitiveness of Enterprises and Small and Medium-sized Enterprises (SMEs)	MNE	Multinational enterprise
CSO	Central Statistics Office Ireland	MREL	Minimum requirement for own funds and eligible liabilities
CSR	Country specific recommendation	NAMA	National Asset Management Agency
CRE	Commercial real estate	NPLs	Non-performing loans
DSA	Debt sustainability analysis	NTMA	National Treasury Management Agency
ECB	European Central Bank	PMI	Production managers index
EBA	European Banking Authority	PPS	Post-programme surveillance
EDP	Excessive deficit procedure	PTSB	Permanent TSB
EFC	Economic and Financial Committee	SBCI	Strategic Banking Corporation of Ireland
EFSF	European Financial Stability Facility	SGP	Stability and Growth Pact
EFSM	European Financial Stabilisation Mechanism	SME	Small and medium sized enterprises
EIB	European Investment Bank	SPV	Special purpose vehicle
ESM	European Stability Mechanism	SSM	Single Supervisory Mechanism
FTB	First-time buyer	USC	Universal Social Charge
GVA	Gross Value Added	VAT	Value added tax
HICP	Harmonised Index of Consumer Prices	y-o-y	Year-on-year
IBRC	Irish Bank Resolution Corporation		
IDR	In-depth review		
IFRS 9	International Financial Reporting Standards 9		
IMF	International Monetary Fund		

EXECUTIVE SUMMARY

Staff from the European Commission, in liaison with staff from the European Central Bank, visited Dublin from 16 to 19 May 2017 to conduct the seventh post-programme surveillance (PPS) review mission for Ireland. Staff from the European Stability Mechanism also participated in the meetings on aspects related to its Early Warning System. The main objective of PPS is to assess the country's capacity to repay loans granted under the former EU-IMF financial assistance programme and, if necessary, to recommend corrective actions.

While the outlook for the Irish economy remains bright, external risks are significant. Ireland has made substantial progress in addressing crisis legacies, including by repairing private sector balance sheets, reducing public debt and creating employment. Growth of the domestic economy remains robust, driven by positive developments in the labour market, consumption and core investment. However, some of the striking headline figures are heavily distorted by activities of multinational enterprises, including highly variable investment in intangible assets and aircraft. In this context, recent efforts to develop complementary economic indicators are welcome as they could improve the data available to policymakers. Risks to the economic outlook remain tilted to the downside. Uncertainty surrounds the final outcome of the negotiations between the UK and the EU under Article 50 of the Treaty on European Union. Moreover, possible future changes to international tax and trade policies are another potential source of asymmetric shocks.

High external uncertainty puts an even greater premium on prudent fiscal policy amid calls for a 'recovery dividend'. The general government deficit continues to decline, yet the underlying fiscal effort diminished in 2016. This largely reflects in-year spending increases on the back of better-than-expected revenue intakes, which received a boost from corporate tax windfalls in 2015-2016. In the future, it would be prudent to use such funds to accelerate deficit and debt reduction, in particular as many indicators suggest that the economy is already operating close to its potential. Moreover, prudent expenditure management remains essential also to ensure compliance with EU fiscal rules in 2017.

The resilience of public finances to economic fluctuations and adverse shocks could be strengthened by broadening the tax base. In particular, there is scope for a shift toward more sustainable and growth-friendly sources of revenue. The planned 'rainy day fund' and the announced 45 % public debt-to-GDP target go in the right direction, but will need to be spelled out in more detail. The ongoing spending review provides an opportunity to improve the efficiency of public expenditure and reorient it to address capacity constraints and promote inclusive and sustainable recovery.

The recovery of the Irish banks continues but is yet to be completed. Several years after the crisis, banks have deleveraged and their capital positions have significantly strengthened. The quality of the banks' assets has improved mainly as a result of ongoing restructuring, asset sales as well as rising collateral values. Non-performing loans continue to decline but the share of long-term arrears, especially mortgages, is still significant. The strong initial take-up of the *Abhaile* aid-and-advice scheme for mortgage debtors in distress could lead to a broader use of personal insolvency. It is important to continue to ensure the adequacy of provisioning practices.

Subdued credit demand and the banks' legacy issues are still a drag on their profitability, but the outlook for credit growth is improving. While new lending is picking up, on aggregate both households and firms are still repaying more than they borrow. So far, the growth in new lending has been largely confined to specific categories within mortgage and corporate loans. Irish banks are still vulnerable to market distress in the euro area, or possible spillovers from the UK following its decision to leave the EU. Concerns remain that the draft bill enabling the Central Bank of Ireland (CBI) to cap interest rates on variable rate mortgages, if enacted, could have negative implications for the transmission of monetary policy, financial stability and bank competition.

Residential property prices accelerated recently and will need to be closely monitored. On top of brisk economic growth, demand side policies may have exacerbated recent price trends, yet the

fundamental issue remains insufficient housing supply. Completions of new residential housing units increased in 2016 but the supply of homes remains well below estimated demand fundamentals. The government has repeatedly and actively intervened in the residential property market but it will still take time to deliver an adequate supply of new homes. Certain building requirements still present a barrier to the construction of apartments, while the new National Planning Framework could facilitate a more stable housing market by enabling a coherent spatial distribution of housing and supporting infrastructure. Current price developments are not being driven by credit. The annual review of the macroprudential measures in the mortgage market provides an opportunity to ensure that the calibration of tools remains appropriate.

Risks for Ireland's capacity to service the European Financial Stability Mechanism (EFSM) and European Financial Stability Facility (EFSF) debt remain low. The sovereign's financing situation is comfortable and the National Treasury Management Agency (NTMA) plans to maintain strong cash buffers in advance of large redemptions over the medium term, notably in 2019 and 2020. Borrowing conditions for Ireland remain favourable, and the low government bond yields together with stable spreads on the 10-year bonds signal continued market confidence in the economy. The debt sustainability analysis shows that the public debt-to-GDP ratio is expected to decrease further in the medium-term but remains vulnerable to economic shocks. Proceeds from the State's shareholding in banks are expected to contribute positively to the debt ratio.

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1. INTRODUCTION

Staff from the European Commission, in liaison with the European Central Bank (ECB), undertook the seventh PPS review mission for Ireland from 16 to 19 May 2017. The European Stability Mechanism (ESM) participated in the meetings on aspects related to its own Early Warning System. The Single Supervisory Mechanism (SSM) was also represented with staff from both the ECB and the national competent authority, the Central Bank of Ireland (CBI). PPS aims to assess economic, fiscal and financial conditions with the ultimate goal to monitor the repayment capacity of a country that has received financial assistance ⁽¹⁾. There is no policy conditionality under PPS, but the Council of the European Union can issue recommendations for corrective actions if necessary.

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

2. RECENT ECONOMIC DEVELOPMENTS AND OUTLOOK

Recent Developments

The Irish economy grew more rapidly than expected in 2016. Real GDP is estimated to have increased by 5.2 % y-o-y, well above the euro area average, while GNP growth reached over 9 %. GDP growth accelerated in the second half of the year despite heightened economic risks and political uncertainties that emerged over the same period. However, some of the striking headline figures, in particular for investment, are still heavily distorted by the activities of some multinational enterprises (MNEs) in the country.

The growth of the domestic economy remained robust. This was driven by positive developments in the labour market, consumption and investment in construction. Core domestic demand, a measure that excludes investment in intangible assets and transport equipment/aircraft, is estimated to have increased by 3.5 % year-on-year (y-o-y) in 2016 ⁽²⁾.

Headline investment is very variable and should be interpreted with caution. Investment picked up in 2016 by a record of 45.5 %. Much of the surge in Q4 (+162.4 %) can be attributed to intangible assets and was related to imports of intellectual property services, with an offsetting impact on GDP. However, domestic sources of investment had a substantial impact on GDP growth in 2016. Investment in construction was firm in 2016, rising by 13.7 %, well above the 7.7 % increase observed in 2015.

Trade developments remain highly exposed to the activities of multinationals. Export growth slowed in 2016, partly due to the fall in sterling, while imports surged on the back of the activities of MNEs. Consequently, net exports had a significant negative impact on GDP growth. According to national accounts figures, exports of goods weighed on total exports growth. However, goods trade statistics, which exclude 'contract manufacturing' ⁽³⁾ by MNEs, show record high

exports and a record trade surplus in 2016. These contrasting figures point to a slowdown in 'contract manufacturing' in 2016.

The labour market continues to improve. The unemployment rate has declined rapidly and fell to 6.4 % in May. Youth unemployment also declined significantly reaching 11.7 % in May, down from 18.0 % a year earlier. Employment grew by 3.5 % y-o-y in Q1-2017 with increases observable in 11 out of the 14 economic sectors. The highest rates of increase were in information and communication services, up by 8.8 % or 7 500, and the construction sector, up 8.5 % y-o-y or 11 100. Full time employment rose by 5.5 % while part-time work decreased by 3.4 %. The labour force increased by 1.6 % y-o-y, the fastest pace of growth since 2008, helped by the return to net inward migration in 2016. The labour force participation rate also increased slightly, standing at 60.4 %, up from 60 % one year ago.

Consumer price inflation remains low. HICP picked-up in the beginning of 2017 but was flat on an annual basis in May. In April, core inflation stood at 0.4 %. Services price inflation exceeded 3 % driven by rents, insurance and education. Prices of goods continue to be a drag on inflation, partly due to the sterling depreciation, and they fell by more than 2 % y-o-y in April.

Private rents continue to increase rapidly, although the pace of growth has slowed. Rents rose by 7.6 % y-o-y in May 2017, compared to 9.7 % in the same month of 2016. Alternative data from the Residential Tenancies Board indicate that the monthly cost of renting a representative apartment in Dublin in Q4-2016 stood at EUR 1 448 per month, well in excess of the pre-crisis peak of EUR 1 289.

Residential property prices started to rise more rapidly in recent months. The national residential property price index increased by 10.5 % y-o-y in April 2017 up from 5.8 % in the same month of 2016. Dublin prices increased by 8.2 % y-o-y, but substantially below the 13.4 % observed in the rest of Ireland. Price increases had slowed markedly following the introduction of macroprudential mortgage lending rules by the Central Bank of Ireland (CBI) in February 2015. However, market participants have reported a strong increase in

⁽²⁾ Preliminary 2016 data for machinery and equipment and intangible assets have not been published by the Central Statistical Office (CSO) due to confidentiality restrictions, therefore core domestic demand for 2016 as a whole can only be estimated.

⁽³⁾ Contract manufacturing can be defined as the production of goods abroad on behalf of Irish-domiciled multinationals.

demand in the first half of 2017, particularly in Dublin. Property price increases have primarily been driven by persistent supply constraints combined with increases in demand due to rapid economic growth, deteriorating affordability in the rental sector and increased lending in some segments of the mortgage market.

The supply of new residential housing units increased markedly in 2016 but remains far below estimated demand. Completions in the 12 months to March 2017 stood at 15 684, an increase of 19 % on the previous year but still well below estimated household formation rates of over 30 000 per annum⁽⁴⁾. The equivalent figure for Dublin was 4 399, an increase of approximately 36 % on the previous year, but still low compared to an estimated household formation rate in excess of 8 000 per annum. The severe social costs of housing supply constraints are more obviously manifest in the still increasing levels of homelessness⁽⁵⁾.

The commercial real estate (CRE) market remains buoyant, primarily driven by foreign investors. Demand for office space in Dublin was strong in Q1-2017. Around 66 % of occupants were foreign firms, while 41 % of office lettings were from the computer and high-tech sector. Prime office rents increased by 14 % y-o-y in Q1-2017⁽⁶⁾, while office prices increased by 4.7 % y-o-y in the same period⁽⁷⁾. Although there is considerable speculation regarding the potential relocation of financial firms in the aftermath of the UK ‘leave’ vote, the scale and timing of any such moves remains largely uncertain. In contrast to the residential market, the supply pipeline remains

strong with 27 new office buildings currently under development in Dublin city centre⁽⁸⁾.

Public Finances

In 2016, the public deficit improved on the back of strong tax receipts and debt interest savings.

The general government deficit, net of one-offs⁽⁹⁾, fell to 0.7 % of GDP in 2016, 0.4 pp. down on the previous year (Chart 1). Tax revenues, including social security contributions, increased by 4.9 % in 2016, propelled by the strong performance of corporate tax and excise duty. However, these gains have been partly off-set by the reduction in non-tax revenues⁽¹⁰⁾. Spending has also increased, primarily due to increases in the public wage bill (2.8 %), intermediate consumption (5.3 %) and public investment (12.7 %). At the same time, savings on interest payments, due to relatively low interest rates, also contributed to the decline in the deficit.

⁽⁴⁾ Economic and Social Research Institute (2016) Ireland’s Economic Outlook: Perspectives and Policy Challenges

<https://www.esri.ie/publications/irelands-economic-outlook-perspectives-and-policy-challenges/>

⁽⁵⁾ In Dublin, there were 1 410 homeless adults with dependent children in February 2017, compared to 1 063 in February 2016.

<http://www.homelessdublin.ie/publications>

⁽⁶⁾ CBRE, Dublin Office MarketView, Q1 2017.

<https://researchgateway.cbre.com/layouts/GKCSearch/DownloadFile.ashx?PublicationID=MzgwMjM%253D&user=cGV0ZXIubWNxdWFkZUBlYy5ldXJvcGEuZXU%253D>

⁽⁷⁾ JLL Irish Property Index - Q4 2016.

<http://www.jll.ie/ireland/en-ie/Research/JLL%20Irish%20Property%20Index%20-%20Q4%202016.pdf?473d434d-fd13-4e22-b61f-ca6170a4e4be>

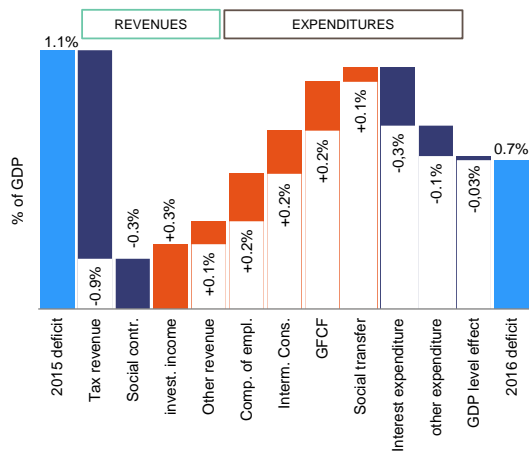
⁽⁸⁾ CBRE Ireland, Ireland bi-monthly research report, March 2017:

<https://researchgateway.cbre.com/layouts/GKCSearch/DownloadFile.ashx?PublicationID=Mzc2MzU%253D&user=cGV0ZXIubWNxdWFkZUBlYy5ldXJvcGEuZXU%253D>

⁽⁹⁾ The headline deficit figures are distorted by significant one-off transactions. These relate to the deficit-increasing restructuring of a state owned bank’s capital base in 2015 (0.8 % of GDP) and the deficit-reducing EFSF pre-paid margin repayment in 2016 (0.2 % of GDP) and the adjustment to the EU budget contributions (0.1 % of GDP).

⁽¹⁰⁾ The fall is primarily due to the gradual decline in bank guarantee fees, interest and Central Bank income directly attributable to financial crisis measures, as well as lower dividends from state-owned companies.

Graph 2.1: 2016 public deficit improvement (net of one-offs)



Source: European Commission

The government's fiscal effort in 2016 fell short of the required adjustment. Ireland achieved an improvement of 0.3 % of GDP in the structural balance in 2016, below the recommended structural adjustment of 0.6 % of GDP under the Stability and Growth Pact (SGP). Similarly, the growth of net government expenditure⁽¹¹⁾ exceeded the expenditure benchmark by a wide margin implying a deviation from the recommended adjustment path towards the Medium Term Objective (MTO)⁽¹²⁾. Irrespective of the difficulties in estimating Ireland's position in the economic cycle, the reduction of fiscal effort reflects the government's fiscal policy stance.

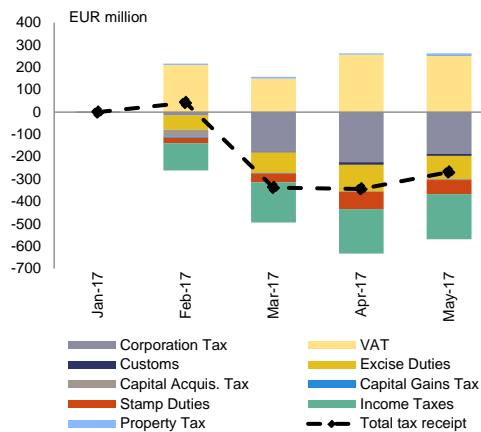
Tax revenues through end-May 2017 were below government targets. Although receipts were slightly better than expected in May, partially

⁽¹¹⁾ Net government expenditure is comprised of total government expenditure excluding interest expenditure, expenditure on Union programmes fully matched by Union funds revenue and non-discretionary changes in unemployment benefit expenditure. Nationally financed gross fixed capital formation is smoothed over a 4-year period. Discretionary revenue measures or revenue increases mandated by law are factored in. One-off measures on both the revenue and expenditure sides are netted out.

⁽¹²⁾ The assessment followed an agreement by the Economic and Finance Committee (EFC) in late 2016 to systematically exclude one-offs from the deviation computed based on the Expenditure Benchmark pillar. The Irish authorities have expressed their disagreement with the application of this approach for 2016, as they consider it a retroactive application of the technical change to the Expenditure Benchmark assessment.

reversing the shortfall of the previous months, on a cumulative basis tax revenues at the end of May were still behind the government's target by EUR 268 million. Household and corporate income tax were particularly disappointing, coming in EUR 202 million and EUR 185 million below projections respectively⁽¹³⁾, while VAT receipts were EUR 265 million above expectation and up by 13.3 % on the same period of 2016. Although it is still early in the year, developments in income taxes receipts need to be carefully monitored. In particular, the continued weak performance of the Universal Social Charge (USC) paid by employees could reflect either overly ambitious tax projections or an underestimation of the costs of the 2017 USC rate cuts⁽¹⁴⁾.

Graph 2.2: End-May 2017 cash return: tax collected vs. government expectations



Source: Department of Finance

Overall, expenditure has so far largely remained under control. End of May data showed overall spending remained broadly consistent with targets across all departments. Current expenditure was up 3.3 % y-o-y and significantly below profile (EUR 254 million). The health sector, a frequent source of overspending, has been keeping within its budget limit so far.

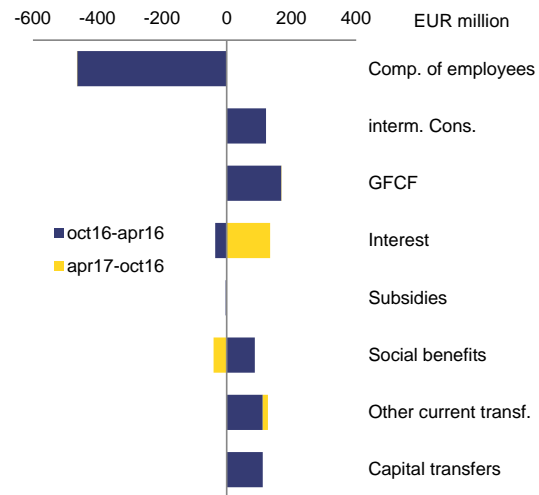
⁽¹³⁾ The government underlined that the shortfall against target is attributable across a range of income tax components, some of which are not directly related to employment or wage developments such as Deposit Interest Retention Tax, Life Assurance Exit Tax, Dividend withholding Tax, etc.

⁽¹⁴⁾ The government is also examining whether drivers of USC payments from self-employed could have been underestimated. This would result in higher-than-expected tax intakes, but only after November when the self-employed are expected to pay their income taxes.

Capital expenditure was up 29.3 % y-o-y and was broadly on profile. However, spending pressures are likely to emerge on the back of recently agreed public sector pay increases, which will have a perceptible impact particularly in the health sector, which accounts for 1/3 of total public sector employment.

Statistical revisions to historical budgetary data remain an issue. Despite the best efforts of the Central Statistics Office (CSO), shortcomings in statistical reporting persist especially at local government level and on the expenditure side. 2014 and 2015 were complicated by the formation of Irish Water and the difficulties in identifying the correct statistical treatment of the associated asset and liability transfers made by local authorities. Latest statistical notifications (see Chart 3) showed significant data revisions to Compensation of Public Employees (around -0.3% of GDP) due to a change in the methodology, Gross Fixed Capital Formation (around +0.2 % of GDP) and Social benefits (+0.1 % of GDP). Those revisions explain most of the differences between the 2017 budget and the 2017 Stability Programme projections⁽¹⁵⁾. Generally, large data revisions make budgetary planning difficult. In this context, the establishment of a working group on local government accounts is welcome.

Graph 2.3: Revisions to Government finance statistics (year 2015)



Source: Central Statistics Office

Financial Sector

The recovery of the Irish banks continues but is yet to be completed. Banks have deleveraged substantially since the crisis due to non-core portfolio sales and repayments generally outstripping new loans. The contraction in banks' loan books is concentrated primarily in the UK, commercial real estate (CRE) and the buy-to-let mortgage segment. The domestic banks have continued to strengthen their capital base, with an average CET1 ratio of 15.7 % at the end of 2016, which compares favourably to the EU average of 13.6 %.

Profitability in the banking system was maintained but faces headwinds going forward. At the end of 2016, Irish banks had an average return on assets of 0.8 % and an average return on equity of 8.0 %. These metrics are above the EU average. However, challenges to profitability come from the low yielding tracker mortgages (which still make about half of the domestic banks' mortgage books), the high NPL stock and weak credit demand. In 2016, the domestic banks' average net interest margin improved further, despite the low policy rate environment, and stood at close to 2 % at the end of 2016, albeit with

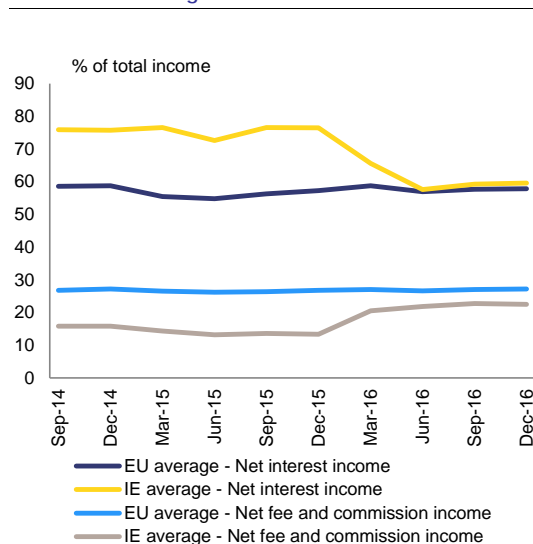
⁽¹⁵⁾ See table A2.3 of the 2017 Stability Programme for a comparison of vintages of receipts and expenditures for 2017.

significant differences among banks⁽¹⁶⁾. Faced with changing operating models, banks are preparing to step up their technology investment. This could put pressure on the cost-to-income ratio in the short-term but should ultimately make banks more efficient.

Irish banks have started decreasing their reliance on net interest income, converging towards the EU average. During 2016 there has been a rebalancing of their income mix towards a higher share of fee/commission income (see Chart 4). Although interest rates are not conducive to savings, private sector deposits continue to increase.

The growth in new lending is confined to specific categories of mortgage and corporate loans. The strong economic recovery leads to increasing demand for new credit. However, the declining stock of outstanding debt indicates that, on aggregate, both households and domestic firms are still repaying more than they borrow⁽¹⁷⁾. There has been recent growth in certain segments of mortgage credit outstanding, and new credit for non-financial small and medium sized enterprises (SMEs) is rebounding, especially in the wholesale, retail and hotels / restaurants sectors⁽¹⁸⁾.

Graph 2.4: Sources of income: domestic banks vs. EU average



(1) Both categories are expressed as a share in total operating income

Source: European Banking Authority

Interest rates on new loans have declined and more tailored credit products are emerging. The average interest rate on new SME loans has declined by 45 basis points in the past 12 months to 4.3 %, but remains above the average interest rate on existing loans of 3.2 %⁽¹⁹⁾. The sectors with the most pronounced increase in new loans have also witnessed the most significant reductions in interest rates. By March 2016, the cost of new mortgage loans declined by about 11 basis points (to 3.1 %) and 27 basis points (to 3.3 %) year-on-year for variable and fixed rate⁽²⁰⁾ mortgages respectively. Banks have been active in tailoring mortgage loan products in order to increase their market shares. In addition, smaller non-bank lenders have entered the market, often targeting specific mortgage profiles (such as buy-to-lets).

As the economy recovers, the stock of non-performing loans (NPLs) continues to decline, albeit with significant differences among banks. Due to a combination of restructuring and sales strategies, the stock of NPLs held by the domestic banks decreased from 18.7 % in December 2015 to 15.7 % at the end of

⁽¹⁶⁾ Bank-specific NIMs: Allied Irish Banks (excluding the Eligible Liabilities Guarantee) 2.25 %, Bank of Ireland 2.19 %, Permanent TSB 1.48 %.

⁽¹⁷⁾ Corporate private debt levels are somewhat distorted by the activities of multinationals. See Commission 2016 Country Report – Ireland, p. 16.

⁽¹⁸⁾ In contrast, commercial real estate (CRE) development activities are still rarely financed domestically, as about two thirds of investment in that sector comes from abroad.

⁽¹⁹⁾ This excludes financial intermediaries.

⁽²⁰⁾ It should be noted that in Ireland, a fixed-rate mortgage product is meant to imply a rate fixation for up to a maximum of 5 years.

2016⁽²¹⁾. Yet the aggregate figure masks an uneven picture, with the NPL ratio ranging from 9.6 % for Bank of Ireland (BOI) to 21.6 % for Allied Irish Bank (AIB) and 27.5 % for Permanent TSB (PTSB)⁽²²⁾. In spite of the substantial decline over the past three years, the NPL ratio remains substantially above the EU average of 5.1 %, indicating the need for further progress. Non-performing exposures (NPEs) stood at 11 % at the end of 2016, compared to the EU average of 4.4 %⁽²³⁾.

The equity position of Irish households has recovered strongly on the back of rising real estate prices. In June 2016, 12 % of owner-occupiers and 23 % of buy-to-let owners were in negative equity, compared with, respectively, 28 % and 45 % in June 2014⁽²⁶⁾. Households' debt-to-income and net worth metrics are improving, although some age cohorts⁽²⁷⁾ remain significantly over-indebted. Due to the high proportion of variable rate mortgages, interest rate shocks could pose a risk to Irish households.

Table 2.1: Financial soundness indicators

	2013	2014	2015	2016	2017
(All year-end data or last available data)					
Total assets (in % of GDP)	593.5	558.0	423.8	396.9	383.7
Share of assets of five largest banks (in % of total assets)	47.8	47.6	46.0	44.3	n/a
Non-performing loans ratio (in % of total loans) (1)	25.7	20.7	14.9	14.7	n/a
Regulatory capital to risk-weighted assets (in %) (2)	20.5	22.7	24.4	23.7	n/a
Return on equity ratio (in %)	-6.8	5.29	5.69	8.84	n/a
Private credit growth (% yoy change)	-6.8	-10.0	-6.4	-3.6	-1.3
Lending for house purchase (% yoy change)	-1.7	-3.9	-1.1	-4.2	1.4
Loan to deposit ratio (in %)	142.2	124.5	115.9	110.2	111.5

(1) IMF Financial Soundness Indicators data.

(2) Regulatory capital refers to total regulatory capital (Tier 1, Tier 2 and Tier 3) after supervisory deductions.

(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

The decline in mortgage arrears slowed down and the share of long-term arrears increased to about 70 % of total arrears. At the end of March 2017, 13.2 % of the total balance of mortgages were in arrears (at least 90 days past due), down from 13.4 % in at the end of 2016 and a peak of 19.9 % in 2013⁽²⁴⁾. Commercial real estate (CRE) and small and medium sized enterprises (SME) NPL ratios were at 28.9 % and 9.4 % respectively at the end of 2016, reflecting a decrease in the ratios of 9 pps. and 4 pps. over the course of 2016⁽²⁵⁾.

⁽²¹⁾ Source: Single Supervisory Mechanism (SSM). This figure differs from previous reports as it is based on EBA's harmonised NPL definition.

⁽²²⁾ Source: Banks' 2016 Annual Reports. The reporting basis may differ from the aggregated statistics (see above).

⁽²³⁾ Source: EBA. The NPE ratio, unlike the NPL ratio, includes debt securities in both the numerator and the denominator.

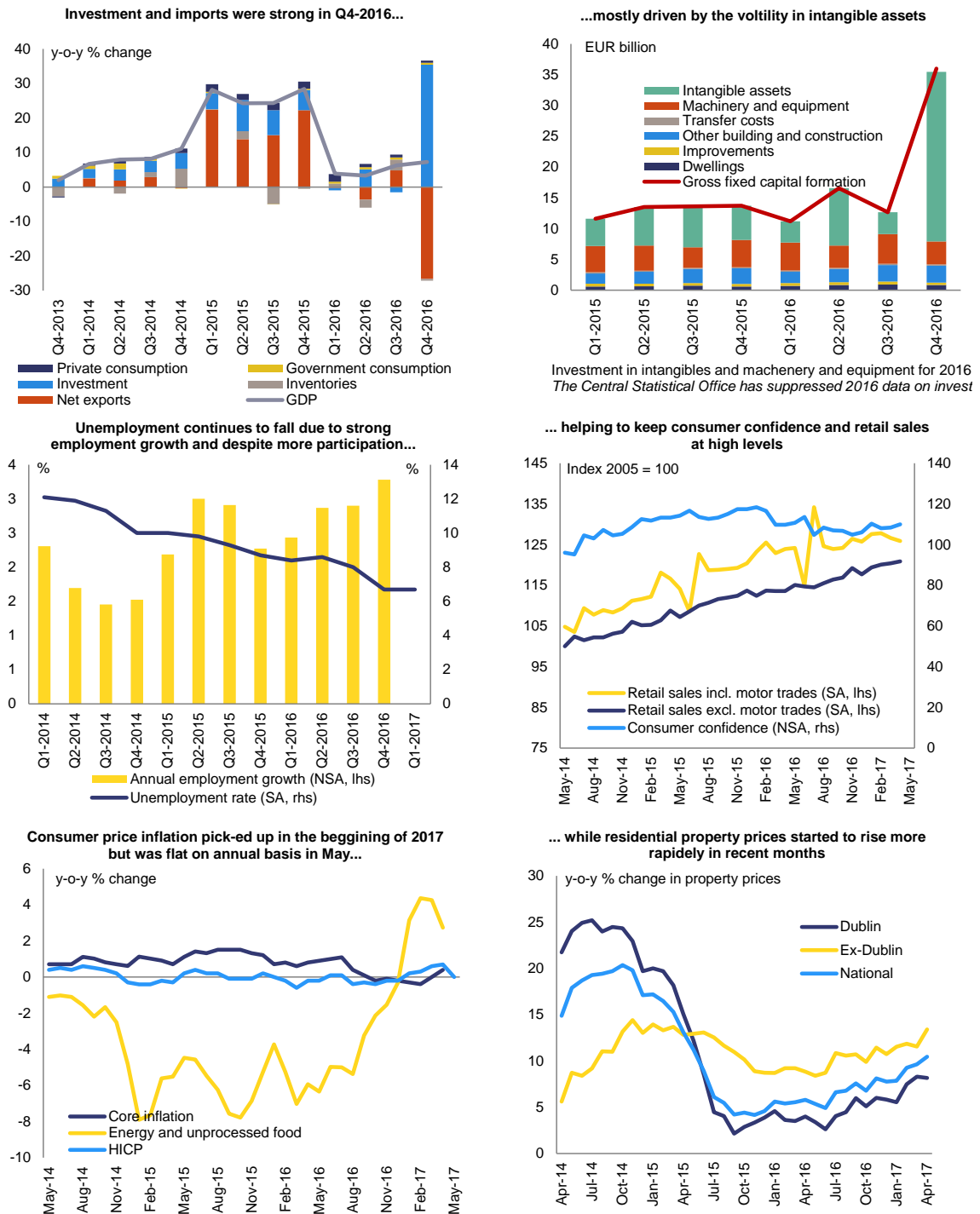
⁽²⁴⁾ Source: CBI Mortgage Arrears and Repossessions Statistics. The data refer to both primary dwelling housing and buy-to-let properties. Accounts in arrears are those 90 days past due (and longer), while accounts in long-term arrears are those over 720 days overdue.

⁽²⁵⁾ The portfolio-specific NPL ratios are sourced from CBI data, that is compiled on the basis of an NPL definition different than EBA's and results in somewhat lower ratios.

⁽²⁶⁾ Household Credit Market Report H1 2015 and H2 2016, Central Bank of Ireland.

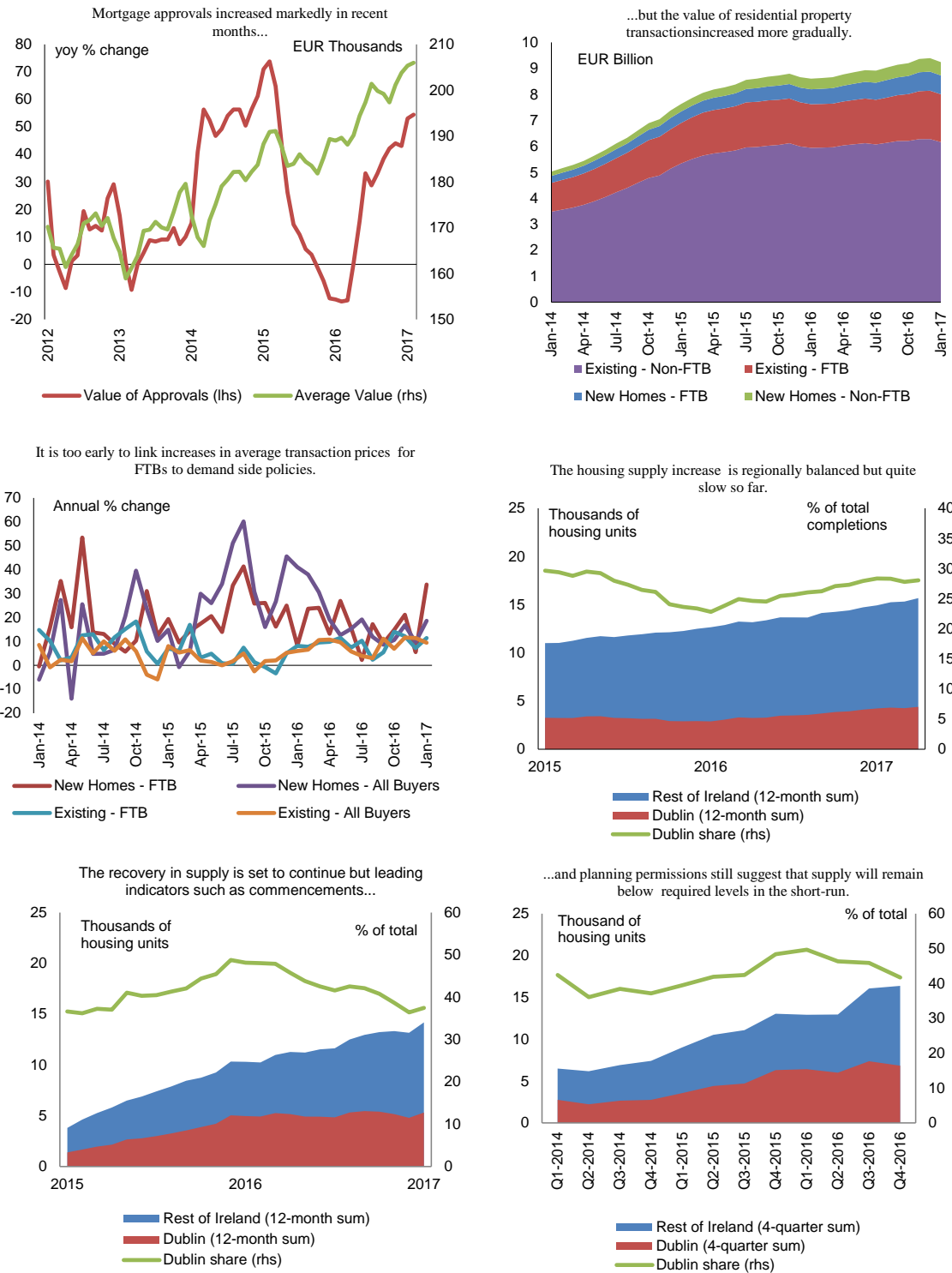
⁽²⁷⁾ For data on the comparatively high indebtedness of Irish borrowers between 35 and 50 years of age, and the related risks, see Fasianos, A., Lydon, R. and McIndoe-Calder, T.: *The Balancing Act: Household Indebtedness Over the Lifecycle*, Quarterly Bulletin 02/April 17, Central Bank of Ireland.

Graph 2.5: Recent economic developments



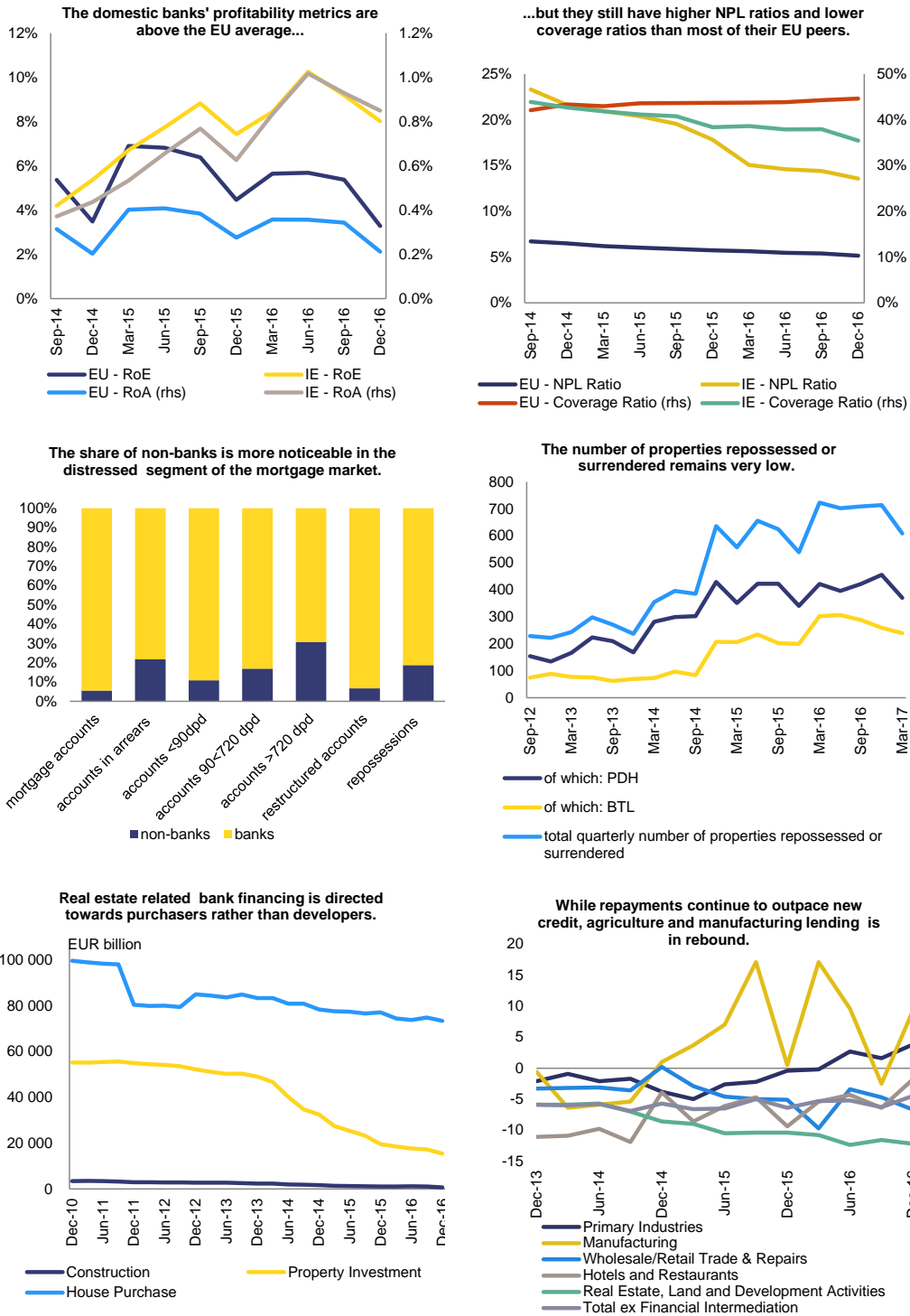
Source: European Commission, Central Statistics Office. Investment in aircraft for leasing and intangibles (proxy) based on staff calculations.

Graph 2.6: Recent residential property market developments



(1) Investment in aircraft for leasing intangibles (proxy) based on staff calculations.
 Source: European Commission, Central Statistics Office.

Graph 2.7: Recent financial developments



(1) RoE - Return on Equity; RoA - Return on Assets
NPL Ratio - non-performing loans/total gross loans; Coverage Ratio - provisions/NPLs
dpd- days past due; PDH - primary dwelling housing; BTL - buy-to-let
Source: European Banking Authority, Central Bank of Ireland

Outlook

GDP is expected to expand at robust rates in the short term. Consumer sentiment has improved again, after declining in the second half of 2016 reflecting the uncertainty surrounding the UK ‘leave’ vote. Retail sales have maintained their momentum⁽²⁸⁾. Business prospects remain positive, with industry and services purchasing managers’ indices (PMI) signalling continued expansion, after they had both declined somewhat in the second half of 2016⁽²⁹⁾.

Domestic demand is expected to remain firm, despite heightened uncertainty. A strong labour market, combined with continued robust wage growth, improving household balance-sheets and subdued inflation are expected to support consumption in the short term (see Table 1). Private consumption is projected to increase by around 2¾ % in 2017 and 2018. The recovery in the construction sector should also support domestic demand, including by providing increased employment.

Leading indicators suggest that the recovery in construction is likely to accelerate. Planning permissions were granted for 16 375 units in 2016, with 6 835 of these located in Dublin. The number of residential housing units commenced over the last year stood at 14 192 in March 2017, an annual increase of 38 %. Around 37 % of these units were in Dublin. The increase in residential construction activity is welcome in so far as it is necessary to ameliorate the social costs of the current housing shortage. The Economic and Social Research Institute (ESRI) expects residential completions in the region of 18 500 in 2017. However, it expressed concern that a very rapid recovery in the construction industry could raise the risk of overheating the broader economy⁽³⁰⁾. Overall, investment in dwellings is expected to grow by approximately 20 % in 2017 and 2018 respectively supported by government policies.

Total investment growth is expected to remain firm but at lower rates than observed in the last two years. While construction activity is expected to remain an important driver of domestic investment in the medium term, it cannot be excluded that headline investment figures continue to be affected by movements in intangible assets.

Public investment is forecast to grow gradually. It is projected to reach 2 % of GDP in 2018, in line with the government’s revised Infrastructure, Capital and Spending Plan, and helped by the Investment Plan for Europe, following the sharp contraction after the crisis.

Exports are projected to increase in line with global trade in the short term. Notwithstanding the sharp increase in imports in 2016, net exports are expected to contribute marginally to GDP growth in 2017 and 2018. The outlook for exports remains less positive for indigenous firms than for MNEs. This is particularly pertinent in the case of the agri-food sector which is the most exposed to currency fluctuations, with 37 % of their exports going to the UK⁽³¹⁾ in 2016. In Q1-2017, food and beverage exports were up 4.7 % y-o-y in value terms, after they contracted by 5.7 % in 2016.

The outlook for the labour market remains positive. The unemployment rate is forecast to fall to 6.0 % in 2018, due to continued job creation which is expected to offset the further increase in the participation rate and labour force growth. Increased construction activity should strongly support employment in the sector. This may compensate for potential short-run job losses in the sectors most exposed to the trade with the UK. Unit labour costs normalised in 2016, after the steep fall in 2015 caused by the surge in Gross Value Added (GVA), and they are expected to gradually increase in the short term.

Recent efforts to develop complementary economic indicators are welcome. Following the surge in 2015 GDP, and based on recommendations by the Economic Statistics

⁽²⁸⁾ Seasonally adjusted, the volume of retail sales increased in April by 1.6 % y-o-y. If motor trades are excluded, ‘core’ sales increased by 6.4 % over the same period.

⁽²⁹⁾ Industry PMI reached 56 in May compared with 52 a year earlier; the service PMI was slightly down in May at 59 in May, from 62 the same period last year.

⁽³⁰⁾ ESRI, Quarterly Economic Commentary, Spring 2017. <https://www.esri.ie/pubs/QEC2017SPR.pdf>

⁽³¹⁾ According to Bord Bia. <http://www.bordbia.ie/industry/manufacturers/insight/publications/MarketReviews/Documents/Export-Performance-and-Prospects-2017.pdf>

Review Group from December 2016 ⁽³²⁾, the CSO will publish from mid-2017 an adjusted annual indicator for the domestic economy. The new indicator will adjust gross national income (GNI) for depreciation on foreign-owned domestic capital and the retained earnings of re-domiciled companies. The Balance of Payments and International Investment Position data will also be adjusted. More reliable indicators of underlying domestic economic activity could improve the information available to policymakers.

Inflation is expected to increase gradually but remain moderate in the short term. Oil prices, which have driven the recent fluctuations in the HICP, will be critical in determining the outlook for headline inflation over the next year. Core inflation should continue to recover slowly due to upward pressure from the services sector including rapidly increasing residential rents, related to the limited supply of residential property.

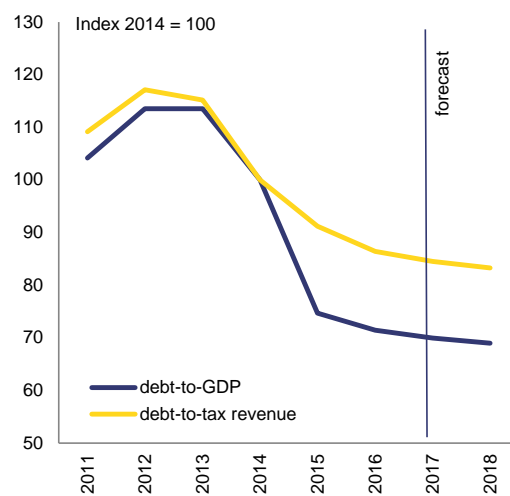
Risks to the macroeconomic outlook remain tilted to the downside. Considerable uncertainty continues to dominate the economic landscape. It mainly relates to the final outcome of negotiations between the UK and the EU, as well as potential changes in the international tax and trade policy environment. The activities of multinationals could impact GDP growth in either direction.

Public finances are expected to improve in 2017. Despite the expansionary measures in Budget 2017, of around 0.5 % of GDP in tax cuts and spending increases, the general government deficit is projected to fall to 0.5 % of GDP in 2017. This represents a 0.2 pp. improvement compared to the deficit, net of one-offs, in 2016. Projections are based on the expectation of relatively robust increases in tax revenue (5.0 % y-o-y) and a rebound in current primary expenditure (3.8 % y-o-y) amid upward pressure on public wages. Considerable downside risks remain, reflecting the volatility of some revenue sources and uncertainties surrounding the economic outlook.

The government debt-to-GDP ratio is set to decline further. According to the Commission 2017 spring forecast, gross general government

debt is projected to gradually decline from 75.4 % of GDP in 2016 to 73.5 % of GDP in 2017 and to 72.7 % in 2018, assuming robust GDP growth and primary budget surpluses of more than 1½ % of GDP over the forecast horizon. However, debt as percentage of total tax revenues declined at a more moderate pace over the same period, giving a less encouraging picture.

Graph 2.8: Alternative public debt indicators (2014 = 100)



Source: European Commission

⁽³²⁾http://cso.ie/en/media/csoie/newsevents/documents/reportoftheeconomicstatisticsreviewgroup/Economic_Statistics_Review_%28ESRG%29_Report_Dec_2016.pdf

Table 2.2: Main features of country forecast - Ireland (Spring 2017)

	2015			Annual percentage change						
	bn EUR	Curr. prices	% GDP	97-12	2013	2014	2015	2016	2017	2018
GDP	255.8	100.0	4.2	1.1	8.5	26.3	5.2	4.0	3.6	
Private Consumption	87.3	34.1	3.8	-0.3	1.8	5.0	3.0	2.8	2.7	
Public Consumption	32.1	12.5	3.5	-1.3	4.5	0.3	5.0	3.2	2.3	
Gross fixed capital formation	54.2	21.2	4.1	-5.7	18.3	32.9	45.4	6.7	5.6	
of which: equipment	16.4	6.4	7.4	-6.3	24.2	3.0	4.2*	7.5	6.5	
Exports (goods and services)	317.2	124.0	8.2	3.1	14.4	34.4	2.4	3.9	4.3	
Imports (goods and services)	236.0	92.2	7.9	1.1	15.3	21.7	10.3	4.1	4.6	
GNI (GDP deflator)	203.9	79.7	3.4	5.1	8.7	18.2	9.0	4.2	3.9	
Contribution to GDP growth:										
Domestic demand			3.3	-1.5	4.9	8.9	11.3	3.3	2.9	
Inventories			0.0	-0.1	1.3	-0.8	0.4	0.0	0.0	
Net exports			1.2	2.3	1.9	18.3	-6.5	0.6	0.7	
Employment			2.1	2.5	1.7	2.5	2.7	2.6	2.1	
Unemployment rate (a)			7.5	13.1	11.3	9.4	7.9	6.4	5.9	
Compensation of employees / head			3.9	1.4	1.8	2.8	2.9	3.0	2.5	
Unit labour costs whole economy			1.8	2.8	-4.5	-16.5	0.5	1.6	0.9	
Real unit labour cost			-0.7	1.4	-3.4	-20.4	1.8	0.4	-0.3	
Saving rate of households (b)			-	10.3	10.9	10.7	10.5	10.4	10.3	
GDP deflator			2.6	1.4	-1.2	4.9	-1.2	1.2	1.3	
Harmonised index of consumer prices			2.3	0.5	0.3	0.0	-0.2	0.6	1.2	
Terms of trade goods			0.5	0.9	-5.6	8.3	-0.8	-0.1	-0.1	
Trade balance (goods) (c)			21.7	19.1	21.1	43.2	38.7	38.0	37.3	
Current-account balance (c)			-1.7	2.1	1.7	10.2	4.7	4.8	5.0	
Net lending (+) or borrowing (-) vis-a-vis ROW (c)			-1.3	1.6	-1.8	9.7	2.6	4.6	4.8	
General government balance (c)			-3.5	-5.7	-3.7	-2.0	-0.6	-0.5	-0.3	
Cyclically-adjusted budget balance (d)			-3.7	-3.4	-3.9	-2.8	-1.5	-1.1	-0.3	
Structural budget balance (d)			-	-3.8	-3.8	-2.0	-1.7	-1.1	-0.3	
General government gross debt (c)			50.7	119.5	105.3	78.7	75.4	73.5	72.7	

(a) as % of total labour force. (b) gross saving divided by adjusted gross disposable income. (c) as a % of GDP. (d) as a % of potential GDP.

* Estimated. The CSO suppressed 2016 data on investment in intangibles and machinery and equipment for confidentiality reasons.

Source: European Commission

3. POLICY ISSUES

3.1. PUBLIC FINANCES

3.1.1. Compliance with the Stability and Growth Pact

Ireland may not fully comply with EU fiscal rules in 2017. The assessment of the 2017 Stability Programme⁽³³⁾ points to a risk of a significant deviation from the required adjustment path towards the medium-term objective (MTO) over 2016 and 2017 when taken together⁽³⁴⁾. Specifically, for two consecutive years government expenditure, net of discretionary revenue measures and one-offs, is expected to grow well above the rate which would ensure convergence to a balanced budget in structural terms. This reflects the government's policy of exhausting all available *fiscal space*. Therefore, spending control across all levels of government remains key as a small deviation from the planned expenditure may lead to non-compliance with EU fiscal rules in 2017.

The government is targeting a balanced budget by 2019. The 2017 Stability Programme projects a steady decline in the headline deficit until a surplus of 0.1 % of GDP is reached in 2019. It estimates a structural deficit of 0.5 % of GDP in 2018, consistent with the achievement of Ireland's MTO. These projections take into account the expansionary measures adopted in 2017 (around 0.5 % of GDP) and the full use of the available fiscal space, as estimated in the budget, for the coming years⁽³⁵⁾. The fiscal expansion is taking place amid a recovery that is increasingly led by domestic demand. With most economic indicators back to pre-crisis levels and the unemployment rate rapidly declining, the current fiscal stance is

⁽³³⁾ https://ec.europa.eu/info/sites/info/files/07_ie_sp_assessme nt.pdf

⁽³⁴⁾ This additional requirement refers to the average of the annual deviations of each pillar in two consecutive years. The significant deviation threshold for the two-year average is 0.25 % of GDP.

⁽³⁵⁾ The resources available for policy interventions are allocated to spending increases and tax reductions at a ratio of 2:1, as set out in the government's programme. More details on the indicative allocation of the available fiscal space over 2017-2021 can be found in a Department of Finance's note, which was published following the presentation of the 2016 Summer Economic Statement: <http://www.budget.gov.ie/Budgets/2017/Documents/SES/Fiscal%20space%20and%20the%20Summer%20Economic%20Statement.pdf>.

likely to be pro-cyclical as the Irish economy already appears to be operating close to its capacity.

3.1.2. Reducing vulnerability to shocks

The government aims to improve the resilience of the public finances to adverse developments. Although the economic recovery is robust and both output and employment are expected to grow at solid rates, the outlook has become more uncertain, creating risks for the still fragile public finances. Against this background, the government is considering measures to increase the resilience of the public finances to economic shocks. Proposals include the creation of a 'rainy day fund', into which budget surpluses could be transferred after 2018, when Ireland is projected to have reached its MTO. During the mission, the government confirmed the target for the debt-to-GDP ratio of 45 %, to be achieved by the mid-to-late part of the next decade, growth dependent, in order to provide an additional safety buffer.

Plans to improve shock-absorption capacity could face hurdles amid calls for a 'recovery dividend' and possible changes in political priorities. At present, operative rules for the rainy day fund still have to be debated by the Parliament. The new debt target of 45 % of GDP, while not particularly ambitious considering the favourable output and interest rate outlook, may be at risk if new demands for spending increases emerge. Therefore, in the short-term efforts should focus on measures to increase the resilience of government revenues to economic fluctuations and adverse shocks.

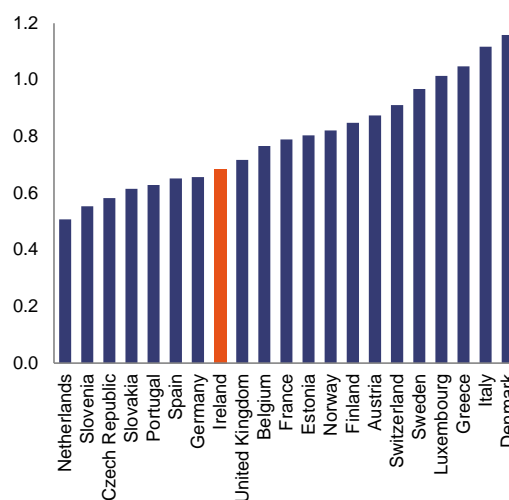
A broader tax base would improve revenue stability in the face of economic volatility. Broadening the tax base generally improves the efficiency of tax system, increases the resilience of tax revenue and, consequently, reduces the vulnerability to economic shocks. Several indicators suggest that the tax base in Ireland is relatively narrow. Recent Commission analysis of VAT gaps⁽³⁶⁾ indicates that Ireland has a

⁽³⁶⁾ https://ec.europa.eu/taxation_customs/sites/taxation/files/2016-09_vat-gap-report_final.pdf

relatively high actionable⁽³⁷⁾ policy gap of 17.7 %, above the EU average of 14.8 %. A similar analysis on the personal income tax (see Chart. 9), indicates that Ireland has a relatively narrow tax base compared to other countries, mostly due to the wider application of generous tax credit and reliefs and the relatively high entry-threshold for first tax-payers.

Recently adopted measures may have narrowed the tax base. In Budget 2017 the government increased the earned income tax credit, the home carer tax credit and introduced a help to buy scheme for first-time buyers (FTBs) of residential property. Each of these measures could contribute to narrowing the tax base and exacerbate risks to long term revenue stability. In addition, the evaluation of the costs and benefits of reduced VAT rates, which apply to an extensive range of sales, is still pending. Conversely, potential measures that could contribute to broadening the tax base, such as maintaining the USC, eliminating reduced VAT rates or increasing property tax revenues, may face political resistance.

Graph 3.1: Spans of personal income tax bases (2015)



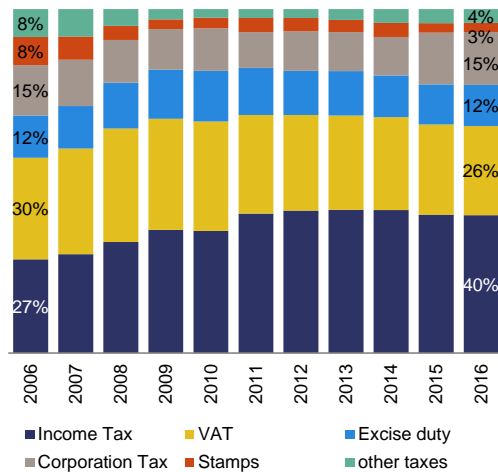
(1) The spans of tax bases is measured as a ratio of the actual income taxes paid by households to a theoretical amount of personal income tax revenues. The latter is calculated by multiplying Wages and Salaries by the average marginal tax rate for a single earner at 67, 100, 133 and 167 percent of the average wage.

Source: OECD, European Commission

A balanced composition of tax sources could enhance revenue stability. There is room for a shift toward more sustainable and growth-friendly sources of revenue. Personal income tax receipts now represent the single largest source of tax revenue at over 40 %, while the share of value added tax (VAT) has fallen to around 26 %, significantly below its pre-crisis level (see Chart 10). Increasing revenue from environmental and property taxation, and eliminating reduced VAT rates could, in addition to broadening the tax base, help re-balancing the tax mix, while enhancing the growth and environmental friendliness of the tax system.

⁽³⁷⁾ Where the loss of theoretical revenue depends on the decision of policymakers.

Graph 3.2: Tax revenue contributions (as % of total tax)



Source: Department of Public Expenditure and Reforms (Databank)

The concentration of Corporation Tax (CT) receipts from the largest companies remains high. In 2016, corporation tax receipts were exceptionally strong for the second year in a row⁽³⁸⁾. The number of net CT payers increased by 11 %⁽³⁹⁾. Payment by companies monitored by the Revenue Commissioners' Large Cases Division continue to account for a very high proportion (82 %) of total CT revenue and accounted for nearly all of the increase in 2016. However, the share of receipts accounted for by the 10 largest companies declined by 4 pps. to 37 % in 2016, suggesting that CT revenue concentration could have declined somewhat.

However, the increasing share of corporate tax in total revenue poses a risk to Ireland's public finances. Given their now sizeable share in tax revenue (about 15 %) and their inherently volatile nature, being subject to relocation decisions by a small number of large MNEs, it is critical to understand the underlying drivers of CT receipts and establish the durability of the strong revenue

⁽³⁸⁾ In 2015, corporation tax receipts increased by 49 % y-o-y, exceeding government's own projections by EUR 2.3 billion. At the end of 2016, receipts stood at EUR 7 351 million, up by 7 % compared to the previous year and about 11 % (EUR 737 million) above government expectations.

⁽³⁹⁾ Of the EUR 480 million increases in net CT receipts in 2016, EUR 345 million was paid by 14,400 companies that did not pay CT in 2015.

performance⁽⁴⁰⁾. According to Commission estimates, around 35 % of the corporate income tax intake in 2015 and 2016 can be considered a windfall⁽⁴¹⁾. A supplementary analysis on the degree of resilience of corporate tax receipts, using, for instance, payroll taxes paid by companies, could contribute to the government's budgetary assessment and planning.

The Irish authorities are monitoring the potential impact of international tax reforms on Irish CT revenue. The terms of reference for the independent review on corporate taxation in Ireland have been extended to include the issue of sustainability⁽⁴²⁾. The report is due to be published in the coming weeks. Several studies, including by the ESRI and the Commission, have highlighted the potential for European tax reforms to affect inward FDI and/or CT revenue in Ireland⁽⁴³⁾. Possible changes to the US tax system present a considerable risk to Ireland because of the substantial presence of American firms in Ireland.

3.1.3. Spending review and fiscal framework

An ongoing review is set to re-examine government spending priorities. The Minister for Public Expenditure and Reform launched a new spending review on 8 February. The review will

⁽⁴⁰⁾ MNEs transactions in intellectual property may have driven the recent spike in investment and could be linked to the upsurge in corporate tax receipts since 2015. This may be a response to the OECD Base Erosion and Profit Shifting (BEPS) initiative, changes in residency rules aimed at preventing the use of the 'double Irish' tax avoidance scheme, or domestic implementation of measures such as country by country reporting.

⁽⁴¹⁾ See Box 1 of European Commission, Sixth Post Programme Surveillance Report: https://ec.europa.eu/info/publications/economy-finance/post-programme-surveillance-report-portugal-autumn-2016_en

⁽⁴²⁾ <https://www2.deloitte.com/content/dam/Deloitte/ie/Documents/Tax/ie-Public%20Consultation%20Document.pdf>

⁽⁴³⁾ ESRI (2016) Ireland's Economic Outlook: Perspectives and Policy Challenges. <https://www.esri.ie/pubs/EO1.pdf>
European Commission (2011) Impact Assessment on Common Consolidated Corporate Tax Base http://ec.europa.eu/taxation_customs/sites/taxation/files/resources/documents/taxation/company_tax/common_tax_base/com_sec_2011_315_impact_assesment_en.pdf
Seamus Coffey (2016) Presentation to Joint Oireachtas Committee on Finance, Public Expenditure and Reform and Taoiseach on the CCCTB <https://www.oireachtas.ie/parliament/media/committees/finance/2016/Seamus-Coffey---Opening-Remarks.pdf>

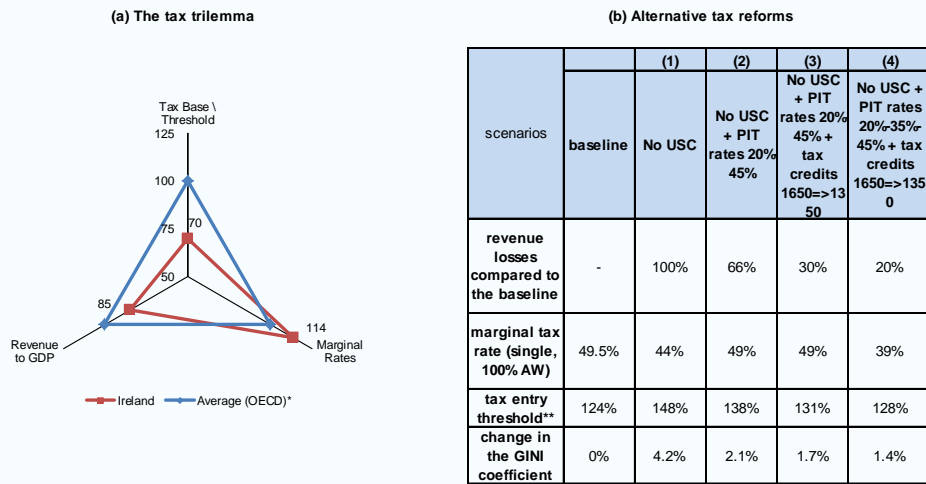
reflect the changed economic and fiscal circumstances and the lessons drawn from previous reviews. Initially, the review will focus on specific critical spending areas, representing around 30 % of current government expenditure, such as drug costs in the health sector, disability and employment programmes in the area of social protection, and public transport. The review is designed to systematically examine day-to-day public spending and will contain recommendations to ensure that policy objectives are being delivered in an efficient manner and that the best use is made of funding in each department.

A parallel review of the medium-term expenditure framework could reinforce the role of the three-year expenditure ceilings. In the past, spending reviews played an important role in restoring the sustainability of public finances. However, there has been little evaluation of the effectiveness and efficiency of expenditure programmes. Despite the evident improvements in the expenditure management framework, year-to-year budgeting at departmental level led to repeated changes to expenditure ceilings which ultimately weakened multi-annual spending planning. In this context, a review of the design of the medium-term expenditure framework may be warranted in parallel to the spending review process and an assessment of its appropriateness in the changed fiscal and economic context.

Box 3.1: Personal income tax in Ireland after the Universal Social Charge (USC) (1)

A purposeful tax. Ireland's personal income tax system has two pillars: a standard income tax, which is generally applicable to all sources of income, and the Universal Social Charge (USC), an individualised tax charged on gross income. The USC, a low-rate broad-based income tax, was introduced in 2011 and it has provided very substantial and stable revenues. The USC aimed to simplify the tax system while strengthening fiscal consolidation, including by broadening the income tax-base. Moreover, as a result of the multiple rate-band structure, the USC is also a highly progressive tax.

Removing the USC has a cost. Despite advantages in terms of revenue generation compared to the standard income tax system, plans to further reduce personal income tax through the complete phasing out of the USC remain central in the government's programme. The Irish government is confronted with a policy trilemma: how to continue to generate revenue and maintain progressivity without imposing very high and distortionary marginal personal income tax rates?



(1) Data are expressed as an index where the average of the available observations equals 100. The tax threshold refers to the percentage of the average wage at which the tax rate exceeds 25%.
* Average of OECD countries for which data was available.
** The tax entry threshold refers to the percentage of the average wage at which the effective tax rate exceeds 25%
Source: (a) OECD, Eurostat and (b) European Commission, Joint Research Centre, based on the EUROMOD model

Alternative income tax reforms cannot easily fulfil all of the government's competing objectives. Using the EUROMOD microsimulation model it is possible to compare the current two-pillar personal income tax system (the baseline scenario) with alternative scenarios where the USC is fully replaced by a single tax on income. The analysis indicates that it would only be possible to recover a substantial part of revenue losses by lowering the entry-point to the tax system via a reduction of the tax credits. At the same time, the introduction of a third, intermediate, tax band would drop the marginal tax rate for the average single employee to the EU average (39 %).

Looking beyond the personal income tax system. Overall, the analysis indicates the difficulty of designing a reform of the existing Irish income tax system that simultaneously reduces high marginal rates and is revenue neutral without being regressive, even though a parametric reform of the income tax system with less negative distributional effects does appear feasible. Overall, the solution to the tax trilemma might lie in looking beyond changes to the income tax system including to other direct and indirect tax heads.

(1) The analysis is based on a forthcoming ECFIN Economic Brief "Personal income tax in Ireland: the future of the Universal Social Charge" by Peter McQuade, Sara Riscado and Stefano Santacroce.

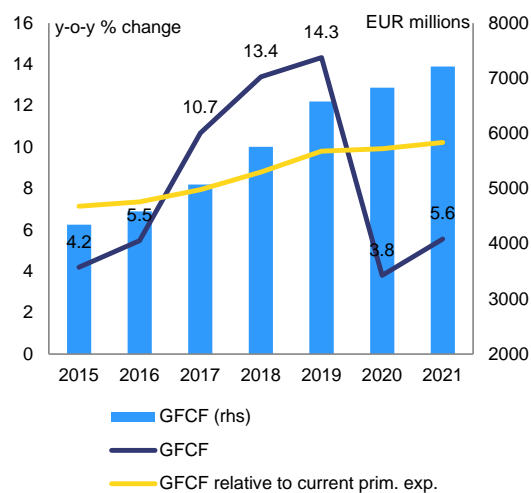
3.1.4. Spending pressures and resource allocation

Negotiations on a new public pay agreement are likely to increase spending pressures. Following a recent Labour Court ruling, some of the terms of the current public pay arrangement (the Lansdowne Road Agreement), which entails gradual wage increases between 2016 and 2018, had to be revised⁽⁴⁴⁾. Work on the new public pay agreement is set to begin before this summer. On 9 May, ahead of these negotiations, the newly established Public Sector Pay Commission released a report setting out some parameters to be considered in the negotiations, such as public-to-private wage gaps and different pension schemes. Notably, the report recognised that negotiations should have full regard to current and future challenges to the economy and the sustainability of public finances, while pay increases must continue to be contingent on the delivery of reforms and productivity. Public pay negotiations are likely to have significant budgetary implications and potential spillover effects to the private sector.

Removing infrastructure bottlenecks is essential for durable and balanced growth. Low government capital expenditure during the recession has resulted in the emergence of bottlenecks in the areas of education, social housing, water supply and transport infrastructure, amongst others. A shift in government expenditure has also negatively affected public sector support for research and development with possible implications for the competitiveness of SMEs. A revision of the Capital Investment Plan (2016-2021) is expected by mid-July. The 2017 Budget anticipated additional investment in the area of social housing and education. As illustrated in Chart 11, Ireland is also planning to increase public investment by rebalancing priorities between current and capital spending.

⁽⁴⁴⁾ The government has already agreed to bring forward to April a EUR 1 000 pay rise for employees earning under EUR 65 000. The cost of these increases is estimated to amount to approximately EUR 120 million in 2017.

Graph 3.3: Government investment



Source: Budget 2017, Department of Finance

Public healthcare expenditure remains subject to upward pressure. The total budget allocated to the health sector in 2017 reached a record level of EUR 14.6 billion. While various measures have been implemented to improve the cost-effectiveness of the health sector (see Country Report for Ireland, 2017), cost pressures remain for pharmaceutical spending, despite a major cost-saving deal concluded with the pharmaceutical industry in 2016. The recently agreed public sector pay restorations also put pressure on the budget as the health sector accounts for one third of public sector employment. Given the weak expenditure control in the past, monitoring the execution of the healthcare budget remains essential.

Uncertainty about the funding of Irish Water functions persists. Water charges have been suspended from July 2016 until July 2017. New legislation is expected in the short term to follow the recommendations of the 'Joint Committee on the Future Funding of Domestic Water Services'. The recommendations of the Committee include that domestic water use should be funded through general taxation and that levies are to be imposed only on households that consume 70 % in excess of the average usage (133 litres per person per day). This means that around 92 % of households will not pay water charges while the remaining 8 % will have the opportunity to apply for exemptions on the basis of large family or medical

conditions. Following the adoption of the legislation the Commission will assess its compliance with the Water framework directive provisions.

The fiscal implications of the abolition of water charges are unclear at this stage. The revenue lost due to the suspension of water charges amounts to EUR 240 million annually. Furthermore, it is not yet decided how the charges paid up to the moment of suspension, amounting to EUR 170 million, will be refunded. A general scheme for the new water charge regime is being drafted and will include, among other elements, a funding model for Irish Water. Furthermore, a working group is expected to be established to review future investment needs.

3.2. FINANCIAL SECTOR POLICIES

Irish banks remain vulnerable to market distress in the euro area, and spillovers from the UK 'leave' vote. Regarding the latter, most risks stem from the potentially negative impact on Irish exports and the value of UK assets, as well as reduced credit demand in the UK. After the sale of its UK mortgages portfolio, PTSB has no more direct UK exposure. BOI and AIB, respectively, retain 38 % and 14 % of their assets in the UK. Some financial companies have intensified their contacts with the supervisor with the view of potentially strengthening their presence in Ireland. Although at the moment this can be regarded as an exploratory phase, the supervisor could face an increase in demand for licenses and a more complex landscape of institutions under supervision.

Elevated NPL levels continue to weigh on bank profitability. While restructuring efforts are ongoing, the sustainability of restructurings has yet to be proven, making it critically important to continue to monitor NPL dynamics after they have been restructured. The banks have been required to submit strategies for distressed credit combined with sufficiently ambitious credit reduction goals. These will be reviewed and challenged as needed by the supervisor.

Irish banks have relatively low provisioning levels, compared to their EU peers. This is partially explained by their NPL reduction

strategies and the provision release due to recovery in collateral values. Not only is the coverage ratio (provisions/NPLs) in Ireland at 35.5 % much lower than the EU average of 44.6 %, it has also been declining in recent years. This contrasts with developments in most other Member States where it has either remained stable or increased. Provision releases are partly the consequence of the strong recovery in real estate prices, and most of the reductions have happened in commercial portfolios (commercial real estate and corporate). Asset sales and restructurings involving write-downs are increasing for portfolios with relatively high coverage ratios. The use of provisions to cover remaining losses, where they occur, could leave the remaining NPLs relatively under-provisioned and pose a limit to the further use of these solutions. It is important to ensure that provisioning is maintained at appropriate levels.

The banks' resolution strategies are yet to lead to a substantial reduction in long-term mortgage arrears. Banks continue resolving their mortgage NPL stock by restructuring distressed accounts, while in the buy-to-let category they regularly resort to the appointment of a rent receiver to ensure a regular payment-stream. However, as time passes, long-term mortgage arrears (more than 2 years overdue), which now make about 70 % of all arrears over 90 days past due and are usually at some stage of the judicial process in parallel, are less and less likely to be restructured, without substantial write-offs or collateral repossessions. Portfolio sales and securitisations could become more prominent as means of NPL disposal too.

The low number of repossessions remains an obstacle to for accessing collateral. Up and until the last quarter of 2016, 54 % of the mortgage restructurings concluded by the domestic banks involved a loss of ownership, implying a strong reliance on the legal route to repossession, which in itself remains cumbersome and lengthy. Judicial repossessions remain rare, especially for primary residencies. The delay in resolving mortgages in arrears could partly be due to rising collateral values, whereby prolonging a final solution (by frequent adjournments) might be seen as beneficial for both debtors and banks. Such strategies leave the court system overburdened and lead to properties remaining 'locked', which is

particularly undesirable in view of the current supply shortages in the residential property market.

The increase in personal insolvency applications following policy efforts could accelerate the resolution of long-term mortgage arrears. The Insolvency Service of Ireland reported a strong increase in new applications as a consequence of the new *Abhaile* scheme⁽⁴⁵⁾, providing initial free financial and legal advice to mortgage owners in arrears. By mid-May 2017, close to 7,000 vouchers for advice were issued for just over 4,000 properties. Paired with further visibility and public outreach activities, the initiative could reassert insolvency as an effective, fair out-of-court process in the best interest of debtors and lenders. With about half of insolvency arrangements concluded within one year, it is hoped that end-year statistics could already reflect increases in protective certificates issued and arrangements concluded. At the moment, about one third of insolvency arrangements include write-offs, whose average size is a substantial EUR 93,000.

Banks are moving ahead with the implementation of new IFRS 9 accounting standards. There are indications that the impact of the upcoming IFRS 9⁽⁴⁶⁾ standards will vary between banks. Of the banks with sizeable legacy issues in their asset portfolios, those that have relied heavily on forbearance measures are likely to face higher additional provisioning charges. More generally, the impact of the new accounting standards is overall expected to be manageable due to the relatively benign economic conditions and the fairly strong capital positions of the Irish banks.

Banks are making the necessary structural changes towards achieving the minimum requirement for own funds and eligible liabilities (MREL)⁽⁴⁷⁾. All of the top-three Irish

banks are expected to have holding companies in place after the Single Resolution Board, as well as local and cross-border supervisors have indicated their preference for a single point of entry as a bail-in strategy for the banks in the event of a resolution. The exact amount of eligible ('bail-inable') liabilities that banks will need to issue is to be specified by the Single Resolution Board (SRB).

The establishment of the Central Credit Register, agreed during the financial assistance programme, has suffered from numerous delays but is now reaching its final implementation phase. The register should cover all types of lending by the end of 2018. Once fully operational, information on debt would help support a transition from the existing loan-to-income based mortgage borrowing ceiling to one based on debt service-to-income.

A legislative proposal enabling the CBI to limit interest rates on variable rate mortgages, though not enacted, is still being considered by the houses of the Oireachtas. The Competition and Consumer Protection Commission opposed the proposed legislation stating it could be detrimental for consumers⁽⁴⁸⁾. Moreover, the ECB legal opinion on the draft legislation, published in 2016, also highlights risks related to the smooth transmission of monetary policy and financial stability.

Specialized non-bank lenders and distressed debt buyers are becoming more active in the Irish market. However, the scale of their activities remains relatively small to date. For instance, new funds are entering commercial real estate lending activities with the aim of seizing opportunities arising from subdued bank lending. Moreover, several funds have been established with the aim of buying domestic mortgages in arrears.

Access to finance for SMEs is being facilitated by publicly supported schemes. By end 2016, EUR 544 million has been drawn from the Strategic Banking Corporation of Ireland

⁽⁴⁵⁾ <https://www.mabs.ie/en/abhaile/>

⁽⁴⁶⁾ The International Financial Reporting Standard (IFRS) 9 will be the new accounting standard for financial instruments, replacing the current IAS39 from January 1, 2018. It will have a significant impact on banks especially in impairment methodology, as the focus on expected credit losses will require banks to recognize their losses earlier.

⁽⁴⁷⁾ MREL – minimum financial resources required to absorb losses and recapitalise, if needed, a failing bank. Introduced in the Bank Recovery and Resolution Directive, they will be phased in from 2020 until 2022.

⁽⁴⁸⁾ <http://ccpc.ie/central-bank-variable-rate-mortgages-bill-2016>

(SBCI)⁽⁴⁹⁾, which aims to provide cheaper credit to SMEs via on-lenders. In December 2016, the SBCI signed a COSME⁽⁵⁰⁾ agreement with the European Investment Fund. EUR 100 million have already been used under this scheme and additional applications are expected. Further relevant initiatives include the Agriculture Cashflow Support Loan Scheme and a revamp of the Credit Guarantee Scheme.

The privatisation of the domestic banks continues with the sale of shares in Allied Irish Banks announced in late May. The government announced the initial public offering of a c.25 % stake in AIB, where it holds a total of 99.8 % of shares⁽⁵¹⁾. The shares could be listed on the Irish Stock Exchange and the London Stock Exchange by end-June, and will be available to institutional and retail investors alike. An estimated EUR 2.6 - 3 billion is expected following the sale or EUR 3 – 3.8 billion assuming full exercise of an overallotment option⁽⁵²⁾. Furthermore, in an effort to set its share price at a higher level and reduce its volatility, in April 2017 BOI consolidated its shares at a 30:1 ratio. The liquidation of the Irish Bank Resolution Corporation (IBRC)⁽⁵³⁾ is ongoing, with about EUR 3.7 billion of loans still under management and 175 legal cases still pending.

Financial consumer protection measures are advancing. The CBI's ongoing tracker mortgage examination aims to identify mortgages that were denied favourable tracker rates. So far it has found close to 10 000 affected accounts. Moreover, in April 2017 the CBI published the Guide to Consumer Protection Risk Assessment with the

goal of increasing the quality and transparency of financial products.

The National Asset Management Agency (NAMA) is now close to redeeming all of its senior debt. By April 2017, NAMA had redeemed EUR 29.7 billion or over 98 % of its senior debt. It aims to redeem the last EUR 500 million tranche by the end of 2017 and to generate a return of EUR 3 billion by the time it winds down in 2020.

3.3. PROPERTY MARKET AND CONSTRUCTION

The calibration of macroprudential rules appears broadly appropriate. CBI published the first annual review of the mortgage lending rules in November 2016. Following this, the CBI modestly recalibrated the rules to support the flexibility of the macroprudential framework. While carefully communicated by the CBI, some media coverage and public discourse tended to present them as a relaxation. Data from the Banking and Payments Federation of Ireland indicate that the number of mortgages approved increased by just under 12 % in April 2017 compared with the same month the previous year. Actual drawdowns are up by 27.4 % in volume and 39.5 % in value in the first quarter of 2017 relative to the same period last year. The CBI survey of Property Price Professionals now shows that prices are expected to rise by 8 % in 2017.

While demand-side policies such as the Help to Buy (HTB) scheme may have exacerbated recent price trends, the fundamental issue remains supply. While it is too early to attribute the acceleration in house prices to measures such as the HTB scheme, introduced in Budget 2017 for first-time buyers (FTBs), market participants have highlighted its potential impact on demand. The sixth PPS report warned of the potential unintended consequences of policies stimulating demand in an environment characterised by a highly inelastic supply. However, it should be acknowledged that the scope of the scheme is limited and an independent review will be published in advance of Budget 2018.

The supply of new homes remains well below demand fundamentals despite active government intervention. Apartment construction standards, including minimum size requirements,

⁽⁴⁹⁾ Funding for the SBCI is provided by the European Investment Bank (EIB), the Ireland Strategic Investment Fund (ISIF), the German State Development Bank (KfW), the National Treasury Management Agency (NTMA) and the Council of Europe Development Bank (CEB).

⁽⁵⁰⁾ EU programme for the Competitiveness of Enterprises and Small and Medium-sized Enterprises (SMEs)

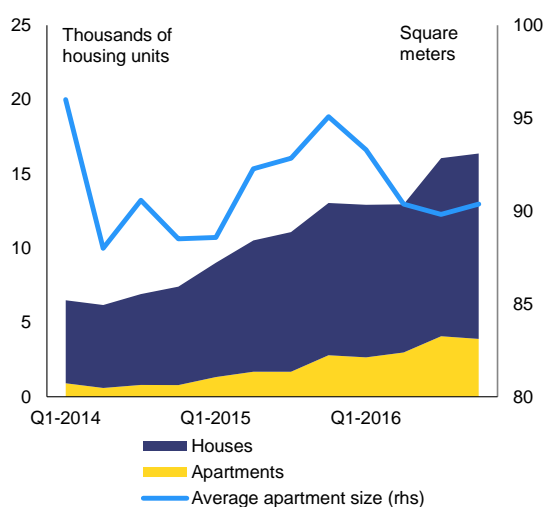
⁽⁵¹⁾ <http://www.finance.gov.ie/sites/default/files/ITF%282%29.pdf>

⁽⁵²⁾ <http://www.finance.gov.ie/sites/default/files/Price%20Range%20and%20Offer%20Launch%20Announcement.pdf>

⁽⁵³⁾ The IBRC, in liquidation since 2013, is an entity managing assets formerly held by the nationalised and resolved banks Irish Nationwide Building Society (INBS) and Anglo Irish Bank.

were eased as part of a package of housing measures announced in 2015. However, the share of apartments granted planning permission remains low (see Chart 12). Height restrictions and underground parking requirements continue to undermine the profitability of apartment developments. The Department of Housing has a number of potentially beneficial policy initiatives. Approval has been granted for 34 public infrastructure projects across 15 Local Authority areas as part of the *Local Infrastructure Housing Activation Fund*. This is expected to contribute to the delivery of 23 000 houses by 2021. The publication of the *Housing Land Map* included an announcement that 2 000 hectares of land in State/Semi-State ownership will be made available for residential development to help boost housing supply.

Graph 3.4: Planning permissions



Source: Central Statistics Office

A coherent and timely spatial plan would help deliver new homes in the right areas and with appropriate supporting infrastructure. The new National Planning Framework is intended to replace the 2002 National Spatial Strategy and is currently in a public consultation phase.

Rents have increased substantially in urban areas but rent controls are unlikely to provide a solution. The limitations on the frequency of rent-reviews introduced by the previous government have done little to dampen rapid rent increases. More recently, the government

introduced rent control measures that will limit rent increases to 4 % per annum for up to 3-years in designated *rent pressure zones*. As highlighted in previous PPS reports, such measures are likely to be counterproductive. Commission research indicates that rent controls have had a destabilising impact on housing markets in other EU countries⁽⁵⁴⁾. Latest information from the Rental Tenancies Board suggest some easing in rents in the Dublin area where the index fell by 1.4 % between Q4 2016 and Q1 2017 although the annual rate of growth is still strongly positive (7.3 %). Outside Dublin prices have grown by 1.3 % quarter on quarter and by 7.5 % annually.

The Action Plan for Housing included a substantial expansion of the direct provision of social housing units. The *Rebuilding Ireland: Action Plan for Housing and Homelessness*, launched in July 2016, committed the government to directly providing 47 000 social housing units. Social housing provision was extended to 19 055 households in 2016 and this is expected to increase to 21 000 in 2017⁽⁵⁵⁾. In March, the European Investment Bank and the Housing Finance Agency jointly announced social housing investment totalling EUR 405 million to support the construction of 1 400 and the upgrading of 700 social housing units.

While much of the demand for CRE is from abroad, close supervision of the sector should be maintained. Budget 2017 introduced changes to the taxation of non-resident property investors⁽⁵⁶⁾. Although these changes have been criticised by industry participants, demand from foreign investors remains strong. Much of this investment is funded by equity rather than Irish bank debt, which mitigates the risk to the domestic economy and financial system. However, potential risks emanating from the CRE market still need to

⁽⁵⁴⁾ Cuerdo, C., Pontuch, P., and Kalantaryan, S., (2014) Rental Market Regulation in the European Union, European Commission, Economic Papers 515.

http://ec.europa.eu/economy_finance/publications/economic_paper/2014/pdf/ecp515_en.pdf

⁽⁵⁵⁾ Rebuilding Ireland (2017) Monthly Housing Activity Report: March 2017.

http://rebuildingireland.ie/news/upward_trajectory-in-house-building/

⁽⁵⁶⁾ The measure targets the tax treatment of funds regularly used to acquire loans in the Irish market. From January 2017, entities classified as Irish Real Estate Funds were required to deduct a 20 % withholding tax on profits distributed to non-resident investors in their funds.

be carefully monitored because of the legacy CRE assets of the domestic banks as well as real economic links (i.e. the construction industry).

4. SOVEREIGN FINANCING ISSUES

Sovereign financing remains comfortable. The Exchequer held EUR 8.6 billion in cash and other liquid assets at the end of 2016. In the year to 8 June, the National Treasury Management Agency (NTMA) raised EUR 8.75 billion in long-term bond funding with a weighted average maturity of approximately 17 years. The NTMA plans to issue EUR 9-13 billion in 2017. The agency continues to pre-fund and plans to maintain strong cash buffers and liquid assets (between EUR 9-10 billion at end-2017) in advance of large redemptions over the medium-term, notably in 2019 and 2020 (around EUR 38 billion).

Both yields and spreads on 10-year bonds have remained reasonably stable. Although government bond yields have increased since Budget 2017, in absolute terms they remain low. The yield on the benchmark government bond maturing in 2026 increased from 0.3 % at the end of September 2016 to less than 0.7 % at the end of March 2017. So far, recent issuance has attracted considerable demand. The weighted average yield on debt issued in Q1-2017 was 1.45 %. This signals continued market confidence in the country.

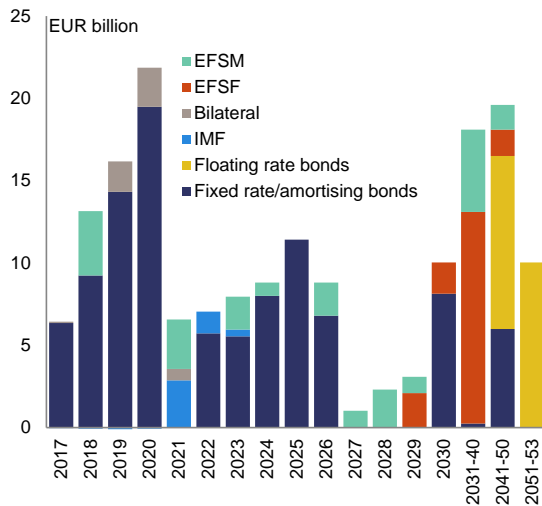
Debt issuance and budget execution progressed as planned in 2016. With large cash buffers and limited financing needs over the next twelve to fifteen months the sovereign is in a good position to withstand potential volatility in markets. The NTMA has recently issued inflation-linked bonds for the first time to diversify the pool of capital available. NTMA is also investigating opportunities to diversify its product base.

ECB monetary policy measures continued to act as support to euro area bond yields over the review period. Under the Eurosystem's expanded asset purchase programme (APP), and more specifically the Public Sector Purchase Programme (PSPP), monthly net purchases of Irish government bonds amounted to approximately EUR 516 million in eligible securities in May 2017. Cumulative net purchases of Irish government bonds under the PSPP stood at EUR 21.3 billion at end-May 2017. The APP (including the PSPP) is scheduled to continue until at least the end of 2017.

The Commission Decision that state aid was granted to Apple has not altered Ireland's sovereign financing plans. This Decision places an obligation on Ireland to ensure that Apple are deprived of the benefit of state aid which the Commission estimate to be up to EUR 13 billion. Ireland and Apple have applied to the General Court of the Court of Justice of the European Union to have the Decision annulled.

The repayment risks for EFSM and EFSF loans remain low. This assumes that Ireland continues to implement prudent economic policies and sovereign market conditions are not impaired. The average maturity of Irish public debt is one of the longest in Europe, with close to 45 % of long-term debt maturing after 2026, and the general government debt-to-GDP ratio is forecast to continue to decline. The redemption profile of EFSF and EFSM loans currently extends until 2042, with the next principal repayment due in 2018 (see Chart 13). However, the 2018 EFSM maturities are expected to be refinanced, owing to the maturity extensions granted in 2013. The average maturity of Ireland's EFSM loans (calculated from original loan disbursement) is now 15.4 years, reflecting the lengthening of Ireland's first EFSM loan (EUR 5 billion) in late 2015. A decision to further extend EFSM loans has to balance the advantage to lock in currently low interest rates with reduced refinancing options in the future if the average maturity of EFSM loans comes close to the agreed maximum average maturity of 19.5 years.

Graph 4.1: Bonds and EU-IMF programme loans repayment schedule (end-December 2016)



(1) The Irish programme was the second euro area assistance programme, and the first financed by two new financial assistance instruments established in 2010, the European Financial Stability Facility (EFSF) and the European Financial Stabilisation Mechanism (EFSM). EFSF loans reflect the maturity extensions agreed in June 2013. EFSM loans are also subject to a seven year extension. It is not expected that Ireland will have to refinance any of its EFSM loans before 2027. However, the revised maturity dates of individual EFSM loans will only be determined as they approach their original maturity dates.

(2) Bilateral loans were provided by the United Kingdom, Sweden and Denmark.

Source: National Treasury Management Agency

Table 4.1: Government financing plans (April 2017)

EUR billion	2016	2017
Funding requirement		
Exchequer borrowing requirement (EBR) (1)	1.0	2.1
Medium/long-term debt redemption (2)	8.2	6.2
Other (3)	5.8	3.7
Total requirement	15.0	12.0
Funding sources		
Government bonds (4)	8.7	11.0
Net short-term paper funding	1.0	1.6
Other (5)	3.0	0.4
Use of cash & other short-term investment balances (- represents an increase)	2.3	-1.0
Total sources	15.0	12.0
Financial buffer (6)	8.6	9.6

2017 figures are estimates as of April 2017. Rounding may affect totals.

(1) 2017 EBR estimate as per 2017 Stability Programme Update (SPU).

(2) Bond maturities, including the early purchase of the 4.6% Treasury Bond 2016 in February 2016, and Amortising Bonds.

(3) 2016 figure includes bond purchases/switches; 2017 figure includes general contingencies and potential bond purchases/switches.

(4) In its 2017 Funding Statement issued in December 2016, the NTMA announced that it plans to issue €9 - €13 billion of Government bonds in 2017. €11 billion is used as an indicative amount in this presentation.

(5) Includes net State Savings (Retail), other Medium/Long-Term funding and, in 2016, rebate of pre-paid margin on initial EFSF drawdown in 2011.

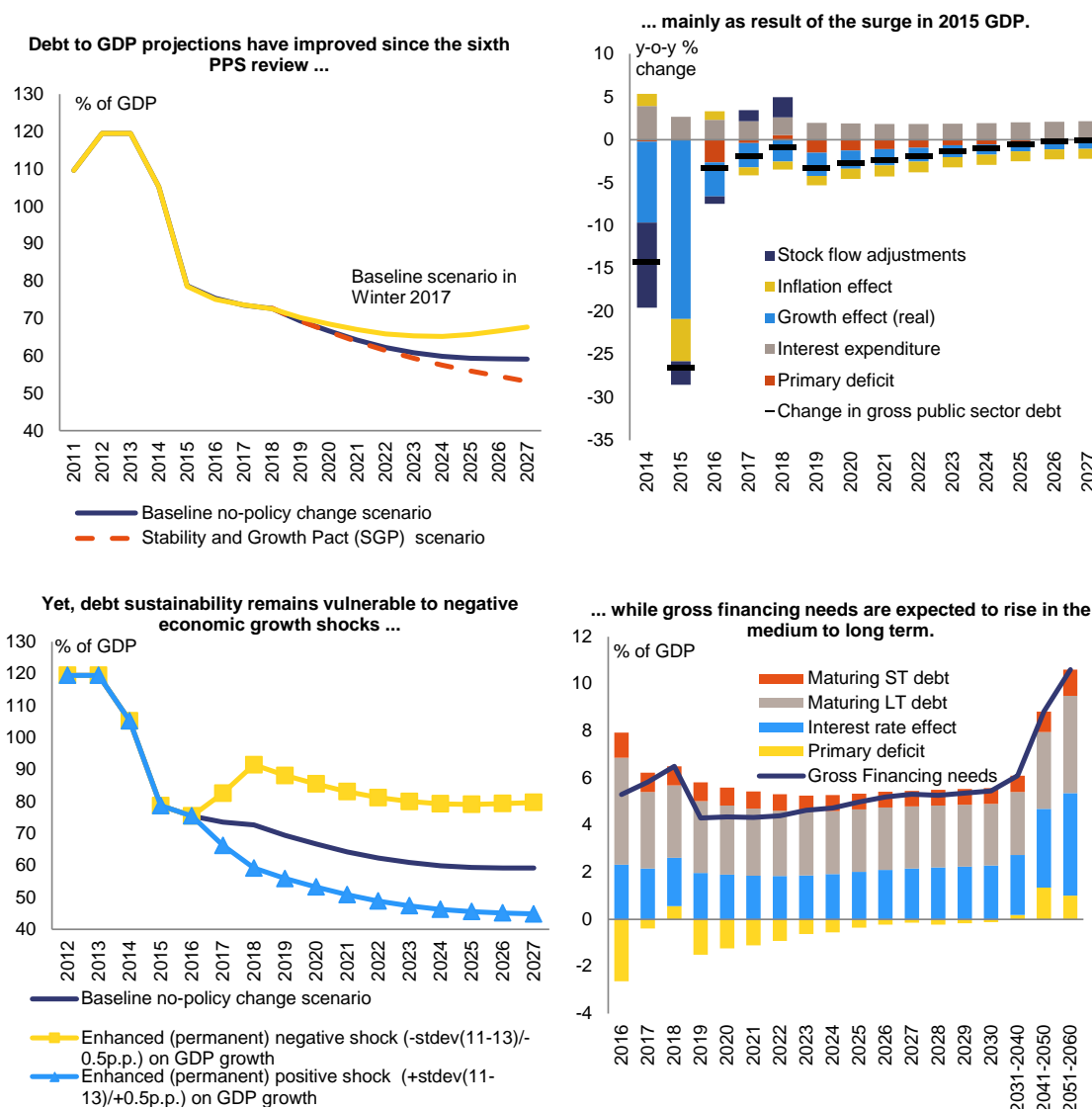
(6) Exchequer cash and liquid assets. Excludes non-liquid financial assets such as Housing Finance Agency (HFA) Guaranteed Notes and CSA Collateral Funding.

Source: National Treasury Management Agency

ANNEX 1

Debt sustainability analysis

Graph A1.1: Gross government debt projections (based on 2017 spring forecast)



(1) The baseline scenario assumes no- policy change from 2018 onward, with a structural primary balance kept constant at last forecast year (cyclical effects until closure of output gap estimated using standard budgetary semi- elasticity). Costs of ageing are included. The large contribution of stock flow adjustment to debt in 2014 is mainly due to the liquidation of the Irish Banking Resolution Corporation (IBRC), which from 2015 should no longer have a significant impact on debt reduction.

(2) The Stability and Growth Pact (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 points until the medium- term objective (MTO) is reached.

(3) The sensitivity tests on real GDP growth consist of enhanced (permanent) negative and positive shocks (-1 standard deviation/+1 standard deviation for the first 2 projection years, followed by a -0.5 percentage point (p.p.)/+0.5 p.p. over the remaining projection period) on real GDP growth applied from the year following the one of last actual data available until the end of the projection horizon (2027). 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.

(4) Details of the gross financing needs projections can be found in Box 2.4 of the Debt Sustainability Monitor 2016.

Source: European Commission

The public debt to GDP ratio is projected to fall further but public finances remain vulnerable. Ireland's government debt-to-GDP ratio is projected to continue to decline, after peaking at 119.5 % in 2012. In 2016, the debt-ratio dropped by 3.3 pps. to 75.4 %. High nominal GDP growth, a decrease in the headline deficit and asset operations, including the cancellation of EUR 3 billion of floating rate bonds, contributed to the drop. The Commission spring 2017 forecast projects the ratio to further fall to 72.7 % in 2018, contingent on robust GDP growth and the realisation of primary budget surpluses of 1½ of GDP. However, the stock of public debt remains very high and is planned to increase by nearly EUR 13.5 billion between 2016 and 2019⁽⁵⁷⁾. Moreover, the disproportionate impact of globalisation on Ireland's macroeconomic indicators means that public debt sustainability needs to be assessed against complementary indicators such as interest-to-revenue and gross debt-to-revenue. The government's announcement of a revised lower debt-to-GDP target of 45 %, to be achieved by the mid-to late 2020s, partly responds to concerns about the inherent volatility of the Irish economy. The recent government decision to begin the floatation of around 25 % of the State's stake in Allied Irish Banks would further reduce the level of gross public debt. The overall value of government holdings in the banks is estimated at around 5 % of GDP.

Medium to long term projections of the debt to GDP ratio have improved since the sixth PPS review. The Commission's latest Debt Sustainability Analysis (DSA)⁽⁵⁸⁾, based on the spring 2017 forecast, shows that if fiscal policy beyond 2018 were to remain unchanged to the last forecast year (2018), the general government debt-to-GDP ratio is expected to decrease to 59.1 % in 2027, just below the Treaty reference value of 60 % of GDP (Graph A2.1). This represents a significant improvement compared to the previous DSA where the debt bottomed out at around 65.2 % of GDP by the middle of the next decade. This is mostly due to slightly higher economic growth and more favourable fiscal projections compared the previous forecast round which carries over into later years. The full implementation of the Stability Programme would put debt on a more firmly decreasing path, reaching 44.3 % of GDP in 2027, comfortably below the 60 % of GDP reference value⁽⁵⁹⁾ and consistent with the 45 % of GDP public debt target of the government.

The sustainability of government debt remains vulnerable to negative economic growth shocks. Ireland's still high level of public debt makes government debt projections very sensitive to variations in economic growth and to the expected size of budgetary adjustment. Risks to long-term debt sustainability relate mostly to changes to the economic outlook — since most of the outstanding stock of debt pays fixed interest rates. According to the Commission's debt sustainability analysis, adverse shocks to real GDP growth — of a magnitude reflecting the country's historical variability of output⁽⁶⁰⁾ — would increase the public debt-to-GDP ratio by 20 pps. by 2027, to about 80 %. On the other hand, save for any potential future changes to market conditions, interest rate risk for the Irish sovereign remains low due to the Ireland's public debt structure and its long debt maturity profile⁽⁶¹⁾. However, gross financing needs are expected to rise in the medium to long term as bonds and loans mature.

⁽⁵⁷⁾ In particular, changes in liquid assets reflect the increase in the funding requirement, owing primarily to large bond redemptions, in 2019-2020 especially.

⁽⁵⁸⁾ The Commission services' DSA makes use of both deterministic and stochastic projections over a 10-year horizon. Alternative scenarios are designed to capture possible future alternative 'states of the world'. The aim is to have a comprehensive set of debt projection results supporting conclusions in a context of uncertainty about future realizations. Scenarios are conceived to be used in an integrated way to reach assessments on debt sustainability.

⁽⁵⁹⁾ The Stability Programme is built under a no-policy-change assumption according to which tax revenues are assumed to increase in line with nominal GDP growth while government primary expenditures are kept broadly constant in level terms. The assumption of broadly stable expenditure in level terms contrasts with both pre-crisis trends and the government's own estimates presented in the last expenditure review.

⁽⁶⁰⁾ This enhanced sensitivity test is designed based on a one standard deviation reduction/increase in real GDP growth, calculated over the last three years of historical data, for two years following the one of last historical data available. After two years of projections, -0.5/+0.5 pp. permanent shocks on GDP growth would be applied till the end of the projections period.

⁽⁶¹⁾ In turn, a permanent 1 pp. increase to short- and long-term interest rates on newly issued and rolled-over debt would raise the public debt-to-GDP ratio by 3.1 pps. by 2027 to about 70.8 %.

ANNEX 2

Supplementary tables

Table A2.1: Fiscal accounts (based on 2017 spring forecast)

	2011	2012	2013	2014	2015	2016	2017	2018
	<i>% of GDP</i>							
Indirect taxes	10.3	10.4	10.7	11.0	8.8	8.9	8.9	8.9
Direct taxes	12.0	12.7	12.7	12.9	10.9	10.9	11.0	11.0
Social contributions	6.0	5.6	5.8	5.7	4.5	4.6	4.5	4.4
Sales	3.0	2.9	2.7	2.5	2.1	1.8	1.7	1.6
Other current revenue	1.6	1.9	1.9	1.7	1.1	0.7	0.7	0.5
Total current revenue	32.9	33.5	33.8	33.7	27.3	26.9	26.7	26.4
Capital transfers received	0.5	0.3	0.3	0.4	0.3	0.5	0.2	0.2
Total revenue	33.3	33.8	34.1	34.1	27.6	27.5	26.9	26.6
Compensation of employees	11.2	10.8	10.3	9.5	7.4	7.3	7.3	7.2
Intermediate consumption	5.1	4.7	4.5	4.6	3.6	3.6	3.6	3.6
Social transfers in kind via market producers	2.9	3.0	2.8	2.7	2.0	2.0	1.9	1.8
Social transfers other than in kind	13.8	13.8	13.1	11.9	9.1	8.7	8.4	8.1
Interest paid	3.3	4.2	4.3	3.9	2.7	2.3	2.2	2.0
Subsidies	1.0	1.1	1.1	1.0	0.7	0.6	0.6	0.6
Other current expenditure	1.5	1.4	1.6	1.4	1.0	1.0	1.1	1.1
Total current expenditure	38.8	39.0	37.7	35.0	26.4	25.7	25.1	24.4
Gross fixed capital formation	2.4	2.0	2.0	2.2	1.7	1.8	1.9	2.0
Other capital expenditure	4.8	0.9	0.2	0.7	1.4	0.5	0.4	0.4
Total expenditure	46.0	41.9	39.9	37.8	29.5	28.0	27.4	26.9
General government balance	-12.6	-8.0	-5.7	-3.7	-2.0	-0.6	-0.5	-0.3
Underlying government balance (EDP)	-8.5	-7.9	-5.7	-3.7	-1.1	-0.7	-0.5	-0.3
	<i>EUR billion</i>							
Indirect taxes	17.8	18.4	19.3	21.2	22.5	23.6	24.8	26.0
Direct taxes	20.8	22.3	22.9	24.9	27.9	29.1	30.7	32.3
Social contributions	10.4	9.9	10.4	11.0	11.4	12.1	12.5	12.8
Sales	5.2	5.1	4.9	4.8	5.2	4.8	4.8	4.8
Other current revenue	2.7	3.3	3.4	3.3	2.9	2.0	1.9	1.6
Total current revenue	56.9	58.9	60.9	65.2	69.8	71.6	74.7	77.5
Capital transfers received	0.9	0.6	0.6	0.8	0.7	1.4	0.5	0.5
Total revenue	57.7	59.5	61.5	65.9	70.5	73.0	75.2	78.0
Compensation of employees	19.4	19.0	18.6	18.3	18.9	19.4	20.4	21.0
Intermediate consumption	8.8	8.3	8.2	8.9	9.2	9.7	10.2	10.5
Social transfers in kind via market producers	5.0	5.2	5.0	5.2	5.1	5.3	5.4	5.4
Social transfers other than in kind	23.9	24.2	23.5	23.0	23.2	23.1	23.5	23.8
Interest paid	5.8	7.3	7.7	7.6	6.8	6.2	6.0	6.0
Subsidies	1.7	1.9	1.9	1.9	1.8	1.7	1.7	1.7
Other current expenditure	2.6	2.5	2.9	2.8	2.6	2.7	3.1	3.2
Total current expenditure	67.1	68.5	67.9	67.6	67.6	68.2	70.2	71.7
Gross fixed capital formation	4.2	3.5	3.5	4.2	4.3	4.9	5.4	6.0
Other capital expenditure	8.3	1.6	0.4	1.3	3.6	1.4	1.1	1.2
Total expenditure	79.6	73.6	71.8	73.1	75.6	74.6	76.6	78.8
General government balance	-21.9	-14.1	-10.3	-7.2	-5.0	-1.5	-1.4	-0.8
Deficit-increasing financial sector measures	7.121	0.3	0.0	0.0	2.1	-0.5	0.0	0.0
Underlying government balance (EDP)	-14.8	-13.9	-10.3	-7.2	-2.9	-1.8	-1.4	-0.8

Source: European Commission

Table A2.2: General Government debt projections (based on 2017 spring forecast)

	2011	2012	2013	2014	2015	2016	2017	2018
Government deficit (% of GDP)	-12.6	-8.0	-5.7	-3.7	-2.0	-0.6	-0.5	-0.3
Government gross debt (% of GDP)	109.6	119.5	119.5	105.3	78.7	75.4	73.5	72.7
levels, EUR billion								
Government deficit	-21.9	-14.1	-10.3	-7.2	-5.0	-1.5	-1.4	-0.8
Gross debt	189.7	210.0	215.3	203.3	201.4	200.6	205.7	213.3
Change in gross debt	45.5	20.3	5.3	-12.0	-1.9	-0.8	5.1	7.7
Nominal GDP	173.1	175.8	180.2	193.2	255.8	265.8	279.7	293.6
Real GDP	167.1	165.2	167.0	181.2	228.8	240.7	250.2	259.3
Real GDP growth (% change)	0.0	-1.1	1.1	8.5	26.3	5.2	4.0	3.6
Change in gross debt (% of GDP)	26.3	11.5	2.9	-6.2	-0.8	-0.3	1.8	2.6
Stock-flow adjustments (% of GDP)	13.6	3.5	-2.8	-9.9	-2.7	-0.9	1.3	2.3
% of GDP								
Gross debt ratio	109.6	119.5	119.5	105.3	78.7	75.4	73.5	72.7
Change in gross debt ratio	23.3	9.9	0.0	-14.2	-26.5	-3.3	-1.9	-0.9
Contribution to change in gross debt								
Primary balance	-9.3	-3.9	-1.4	0.2	0.7	1.7	1.6	1.8
"Snow-ball" effect	0.4	2.4	1.3	-4.2	-22.1	-0.7	-1.6	-1.4
of which								
<i>Interest expenditure</i>	3.3	4.2	4.3	3.9	2.7	2.3	2.2	2.0
<i>Real growth effect</i>	0.0	1.2	-1.3	-9.4	-20.9	-3.9	-2.8	-2.6
<i>Inflation effect</i>	-3.0	-2.9	-1.7	1.3	-3.9	0.9	-0.9	-0.9
Stock-flow adjustments	13.6	3.5	-2.8	-9.9	-2.7	-0.9	1.3	2.3
<i>Implicit interest rate</i>	4.0	3.8	3.7	3.5	3.4	3.1	3.0	2.9

(1) The projections assume no borrowing for precautionary contingencies foreseen in the programme's financing plan. Stock-flow adjustments include a reduction in cash balances from around 14% of GDP at end-2013 to around 4% by end-2016 and other and other financial transactions.

Source: European Commission

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