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Post-Programme Surveillance Report

Ireland, Autumn 2021

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Ireland, Autumn 2021

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This report reflects information available and policy developments that have taken place until 21 October 2021. However, the macroeconomic and budgetary projections, including those underlying the debt sustainability analysis, are in line with the Commission 2021 autumn forecast released on 11 November 2021 (with cut-off date 25 October 2021).

([1]) The report was adopted as Commission Communication C(2021)8554 on 22 November 2021, accompanied by a Staff Working Document (SWD(2021)350).

([2]) ECB Staff participated in this mission, and in the drafting of this report, in accordance with the ECB's competences and thus provided expertise on financial sector policies and macro-critical issues, such as headline fiscal targets and sustainability and financing needs.

ABBREVIATIONS

AIB	Allied Irish Banks plc
CBI	Central Bank of Ireland
CBRE	Coldwell Banker Richard Ellis
CCyB	Countercyclical capital buffer
CET1	Common Equity Tier 1
CSO	Central Statistics Office Ireland
EBA	European Banking Authority
ECB	European Central Bank
EFSF	European Financial Stability Facility
EFSM	European Financial Stabilisation Mechanism
ESM	European Stability Mechanism
EWSS	Employee Wage Subsidy Scheme
GDP	Gross Domestic Product
GNI*	Modified Gross National Income
HICP	Harmonised Index of Consumer Prices
KBCI	KBC Ireland plc
MoU	Memorandum of Understanding
NPL	Non-performing loan
NTMA	National Treasury Management Agency
O-SII	Other systemically important institutions
PPS	Post-programme surveillance
PUP	Pandemic Unemployment Payment
q-o-q	Quarter-on-quarter
RTB	Residential Tenancies Board
RoE	Return on Equity
SME	Small and medium sized enterprises
SPV	Special Purpose Vehicle
SURE	Support to mitigate Unemployment Risks in an Emergency
SyRB	Systemic Risk Buffer
TCR	Total Capital Ratio
TWSS	Temporary Wage Subsidy Scheme
UBI	Ulster Bank Ireland
VAT	Value Added Tax
y-o-y	Year-on-year

EXECUTIVE SUMMARY

The 15th post-programme surveillance mission to Ireland took place online again due to the COVID-19 pandemic. The mission involved European Commission staff, in liaison with European Central Bank (ECB) staff. European Stability Mechanism (ESM) staff participated on aspects relating to the ESM's Early Warning System. International Monetary Fund staff joined the mission in their Article IV context. The meetings took place from 13 to 17 September 2021, in the form of videoconferences.

The Irish economy avoided a recession in 2020 and is on track to record very strong growth in 2021. Exports of multinational corporations led growth in the first quarter of 2021 and a domestic recovery added to growth in the second quarter. Consumer spending rebounded as the economy reopened, nearly reaching pre-pandemic spending levels in the second quarter. Consumer spending is expected to remain strong as the services sector approaches a full reopening and the household saving rate – which largely increased during the pandemic – gradually normalises. Domestic investment also started to recover in 2021, led by buoyant construction activity. The labour market is recovering. Employment is increasing, although it remains partially supported by government schemes. The schemes seem to have successfully limited the risk of scarring on the economy. The generally favourable external environment is likely to add to the current growth momentum. Exports of multinationals are volatile and difficult to predict, but appear set to continue performing very well and contributing to Ireland's real GDP. Exceptionally strong real GDP growth of 14.6% is projected in 2021, followed by a 5.1% increase in 2022 and 4.1% in 2023. Modified domestic demand, which better reflects underlying domestic economic activity, is expected to expand by 7.3% in 2021, 5.3% in 2022 and 3.2% in 2023.

Government support measures counteracted the social and economic impact of the pandemic but increased the deficit and the stock of debt over 2020 and 2021. Policy support is expected to be wound down as of 2022. While strong GDP growth is keeping the rise in the government debt-to-GDP ratio in check, in terms of GNI* this ratio is forecast to reach approximately 106.2% in 2021. Risks to the fiscal outlook are tilted to the downside. Uncertainties remain as to how the pandemic will evolve over the short-term and whether Ireland will need to take fiscal measures to counteract any negative impacts. Changes to the international corporate tax framework might have consequences for this source of revenue as of 2023.

The financial sector has remained resilient to the impact of the pandemic. Irish banks have reported strong capital and liquidity positions well above regulatory requirements. The measures taken by the ECB and Central Bank of Ireland sustained bank lending during the pandemic, while government support to households and companies reduced uncertainty and defaults, also mitigating the impact on the financial system. The government is phasing out loan moratoria and other public support schemes, with most borrowers resuming full repayments. However, the quality of bank exposures to non-financial corporations has worsened somewhat, especially to SMEs, and the adverse effects of the pandemic will likely only be visible after other general support measures end. In this sense, a possible increase in non-performing loans could partially undo the efforts taken over the last years to reduce them. The banking sector returned to profitability in the first half of 2021, partly owing to the very limited additional impairments booked over this period. However, profitability challenges remain for Irish banks and subsidiaries of foreign groups, inducing some foreign groups to withdraw from the Irish retail banking market. The presence of a large non-bank financial sector, including fintechs, creates opportunities for diversification and efficiency gains, but it also challenges existing banks' business models.

The risks for Ireland's capacity to service its debt to the European Financial Stability Mechanism (EFSM) and European Financial Stability Facility (EFSF) remain low. Sovereign borrowing and debt servicing continue to enjoy favourable access to market financing, and Ireland has a strong cash balance that provides some flexibility. Ireland has virtually no refinancing needs in 2021 and it will not have to repay any of its EFSF and EFSM loans before 2023.

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1. INTRODUCTION

This 15th post-programme surveillance (PPS) report was conducted virtually, given the COVID-19 pandemic. Due to travel restrictions the 15th PPS mission to Ireland was again replaced by a set of videoconferences that took place between 13 and 17 September 2021. They involved European Commission staff, in liaison with staff from the European Central Bank (ECB). Staff from the European Stability Mechanism (ESM) participated in the conference calls on aspects related to the ESM's Early Warning System. The International Monetary Fund (IMF) participated in the context of their Article IV review of Ireland. Under PPS the Commission carries out regular review missions to EU Member States that have had an EU-supported financial assistance programme. The objective of the PPS mission is to assess the economic, fiscal and financial situation to ensure the Member State maintains its capacity to service its debt to the European Financial Stabilisation Mechanism (EFSM), European Financial Stability Facility (EFSF) and bilateral lenders ([3]). Acting upon a proposal from the Commission, the Council could recommend corrective measures. As per Regulation (EU) 472/2013, the results of the PPS mission have to be communicated to the relevant committee of the European Parliament, the Economic and Financial Committee, and the Irish Parliament.

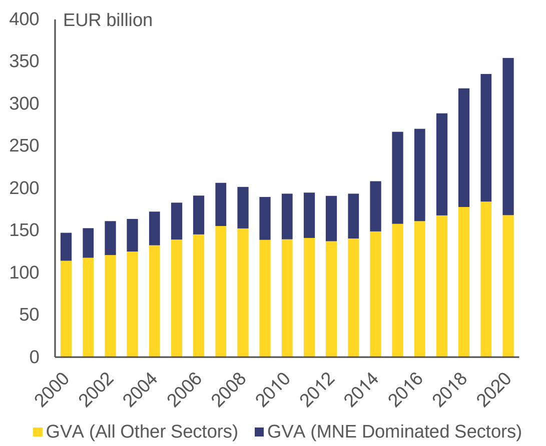
([3]) Ireland already repaid the outstanding bilateral loans from Denmark and Sweden, early and in full. On 26 March 2021, Ireland also completed the repayment of the outstanding bilateral loan from the UK. Under Regulation (EU) No 472/2013, PPS will continue until at least 75% of the financial assistance received under the programme has been repaid. Under the current repayment schedule, PPS will last until 2031.

2. RECENT ECONOMIC DEVELOPMENTS AND OUTLOOK

2.1. MACROECONOMIC TRENDS

Following positive annual GDP growth in 2020, Ireland's economy continued to expand at a very brisk pace in the first half of 2021. Ireland was the only EU economy to avoid a pandemic-related recession in 2020, recording GDP growth of 5.9%. In 2021, the extraordinary performance continued, with the economy expanding by 8.7% q-o-q in the first quarter of 2021, followed by 6.3% q-o-q growth in the second quarter (during which modified domestic demand, a measure capturing domestic economic activity, rebounded by 8.4% q-o-q). The activities of multinational corporations headquartered in Ireland (including contract manufacturing and merchanting ([4])) were behind this fast expansion and their exports remained the main driver of growth in the first half of 2021. These exports mainly consisted of pharmaceuticals and medical equipment in the goods category, as well as information and telecommunication services. Since 2015 the contribution from multinational corporations to gross value added has increased sharply and was particularly large in 2020 (see Graph 2.1), a trend that continued in the first half of 2021.

Graph 2.1: **Real gross value added**



Source: CSO

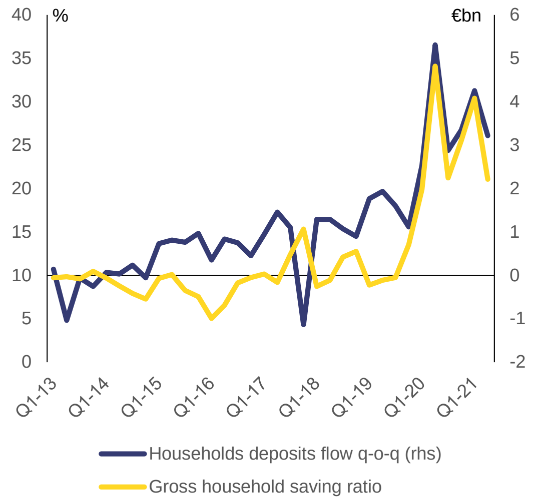
Activity in the domestic sector, as reflected by *modified domestic demand*, started to recover in 2021, more notably in the second quarter, when it surpassed the pre-pandemic level. The gradual lifting of pandemic restrictions led to a jump in private consumption, which increased by 12.6% q-o-q in the second quarter and nearly reached pre-pandemic levels. Domestic investment also rebounded, led by the construction sector. The latter development may help to address the shortage of housing supply in Ireland. Various restrictions during the pandemic obstructed new construction; nevertheless, 15 530 housing starts were registered in the first 6 months of 2021, beating expectations. Government consumption also increased in the first half of 2021, in part due to the extension of various support schemes for workers and businesses.

A very high vaccination rate in Ireland has paved the way for lifting the remaining restrictions and further accelerating domestic recovery. 90% of the adult population was fully vaccinated as of October 2021. Taking that into consideration, the government decided to further ease COVID-19-related restrictions. This is set to provide an additional boost to the economy, particularly the arts, events, catering and hospitality sectors and other large-scale close-proximity services. While the second quarter saw private consumption being primarily driven by consumer purchases of goods, early indicators for the third quarter indicate a shift towards services spending — a trend which is likely to be reinforced in the final quarter of 2021.

The very high household saving rate in Ireland provides considerable scope for accelerated spending by households. The saving rate continues to remain well above the historical average (see Graph 2.2) and its expected decline is likely to support consumption and investment growth well into 2022. It remains to be seen to what extent the additional spending will go into the acquisition or improvement of housing, compared to spending on goods and services. The most recent data show substantial and increasing household spending on housing, where supply bottlenecks persist and price pressures are building up (see 'Housing').

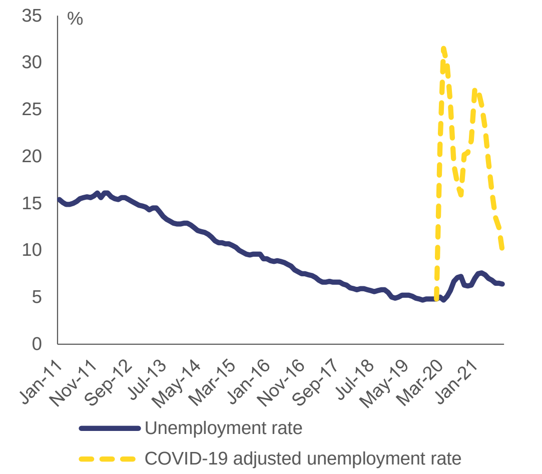
([4]) Under this global production arrangement, goods are purchased by resident companies from non-resident ones and subsequently resold to another non-resident firm, without the goods ever entering the merchant's economy.

Graph 2.2: **Gross household saving ratio and deposits**



Source: CBI, CSO

Graph 2.3: **Unemployment statistics**



Source: CSO

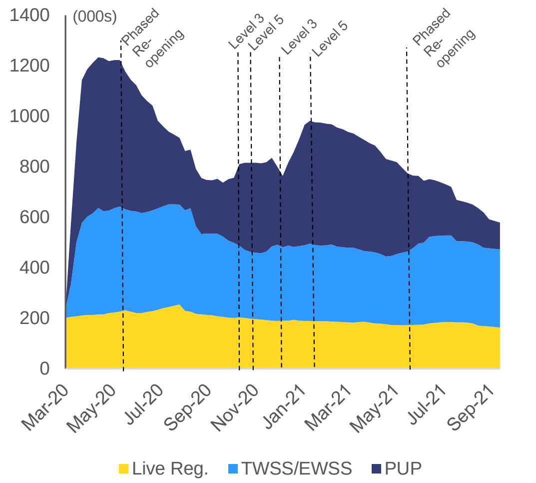
The labour market is rapidly recovering. Since the gradual reopening of the economy, unemployment has substantially declined. The Covid-adjusted unemployment rate, which stood at 31.5% at its April 2020 peak, declined to 12.4% in August 2021 and went down even further to 10.0% in September (see Graph 2.3). This pronounced fall in September is partially explained by full-time students becoming ineligible for the Pandemic Unemployment Payments (PUP) scheme. Employment picked up substantially in the second quarter of 2021 and is showing signs of accelerating further amid a strong economic expansion and the re-opening of labour intensive services sectors. In some sectors, such as the booming construction sector or rapidly-hiring hospitality sector, labour shortages are already reported. Employment expectations, however, moderated over the summer months following the rebounding of business sentiment in spring.

Various government schemes are expected to help avoid scarring to a large degree. Throughout the pandemic workers could rely on the PUP scheme, which was available to people who lost their jobs due to the pandemic (mostly in sectors requiring face-to-face interaction), and on the Employment Wage Subsidy Scheme (EWSS), through which public support was provided directly from pandemic-affected employers to their employees through the payroll system (see Graph 2.4) ([5]). The latter scheme allowed employers to retain their employees, thereby enabling a smooth return to the workplace. The PUP scheme has been extended until February 2022 while the EWSS is set to last until the end of April 2022, to avoid a ‘cliff edge’ surge in unemployment. With domestic recovery progressing and most sectors set to be reopened fully, the government is envisaging the phasing-out of the crisis-related support schemes as of the second half of 2022. The COVID-19 crisis disproportionately affected younger workers in the acute phase of the pandemic. However, while some may experience difficulties re-entering the labour market, female workers and employees aged 55+ are the ones who are likely to face the greatest challenges in returning to non-supported employment ([6]).

([5]) The EWSS replaced the Temporary Wage Subsidy Scheme on 1 September 2020.

([6]) Parliamentary Budget Office (2021) Publication 24 on Labour Market Scarring.

Graph 2.4: **Unemployment and income support recipients**

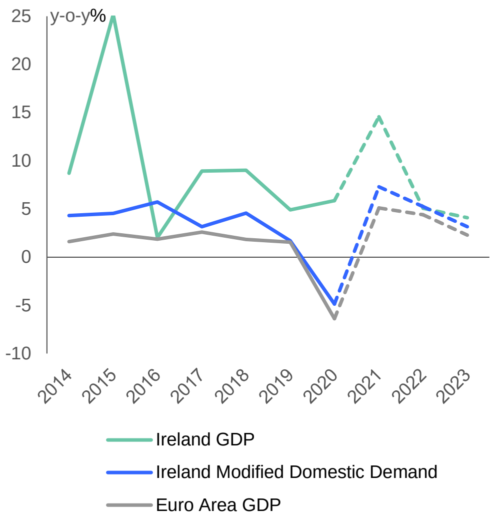


Level 3 – Substantial restrictions
Level 5 – The highest level of restrictions
Source: CSO, Office of the Revenue Commissioners, Department of Social Protection

The health of the corporate sector is surrounded by some uncertainty. As elsewhere in Europe, the worry lingers as to how many Irish companies may have become non-viable firms kept afloat thanks to the public support provided during the pandemic. Furthermore, corporate loans uptake was very modest in the recent period (e.g. in June 2021 new lending to SMEs was 19.3% below the corresponding level of 2019). However, most of the companies surveyed indicated that the reason for low credit demand was a sufficiency of internal funds, rather than difficulties in obtaining a loan. Most of the support for small and medium enterprises that was made available during the COVID-19 crisis (credit guarantees, payment breaks on debt, VAT reductions, as well as grants and loans schemes) is being phased out.

All in all, Ireland's economy is set to grow very strongly, driven by both the domestic and multinational sides. The domestic recovery is clearly gathering speed. High frequency indicators signal strong growth in the third quarter of 2021. Pent-up demand, coupled with ample private sector financial buffers, elevated economic confidence and a tentatively improving external environment have set the preconditions for strong growth in the final quarter of 2021 and into 2022. At the same time, exports of multinational corporations that had been the driving force behind positive growth in 2020 remained very strong in the first half of 2021. While the performance of multinationals is difficult to predict, new investments of headquartered companies, as well as the entry of new multinational companies and bullish export expectations, suggest that their good performance is set to continue to boost Ireland's GDP growth (see Graph 2.5). Real GDP growth was revised up in the Commission 2021 autumn forecast to 14.6% in 2021, 5.1% in 2022 and is projected at 4.1% in 2023.

Graph 2.5: **Real GDP and modified domestic demand**

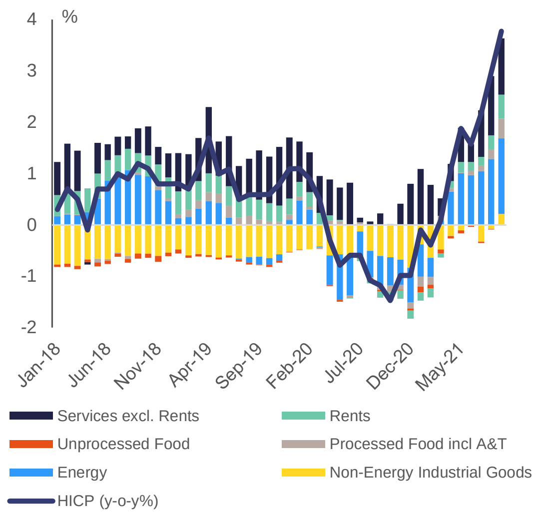


Source: Eurostat, Commission 2021 autumn forecast

Downside risks to the outlook exist. They are associated with the developments of the pandemic and its longer-term impact, in particular the degree of scarring of the economy, the emergence and persistence of global supply bottlenecks, and the evolution of trade frictions between Ireland and the United Kingdom following the UK's departure from the European Union. While the latter impact has not yet fully materialised, the measures taken by the government, including those financed by the European Union's Brexit Adjustment Reserve, are expected to mitigate to a large degree the negative impact on the sectors most affected.

Inflation based on the harmonised index of consumer prices (HICP) substantially accelerated over the summer. Energy prices were by far the dominant driver of inflationary pressures, while a notable increase was also recorded in the prices of services (3.8% y-o-y in September 2021). In the case of the latter, the additional costs associated with the re-opening and re-hiring after the pandemic break period — combined with rising demand — account for rising services prices (see Graph 2.6). The current inflationary momentum is generally considered to be transitory due to the combination of base effects, simultaneous hiring and fixed costs in face-to-face services, supply bottlenecks and the rise in the cost of transport, but it might persist well into 2022. HICP inflation in Ireland is projected at 2.3% in 2021, 3.1% in 2022 and 1.5% in 2023.

Graph 2.6: **HICP inflation components**

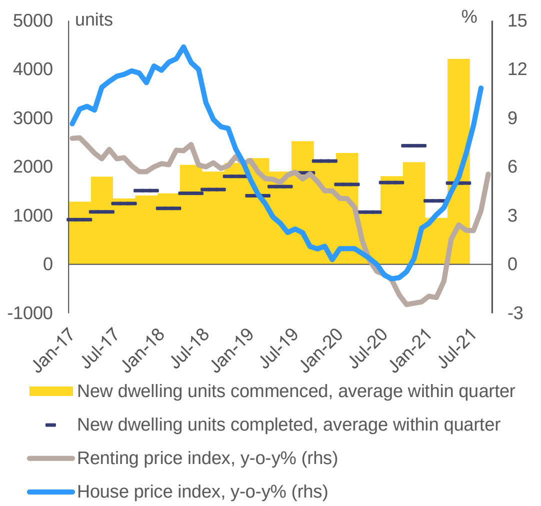


Source: Eurostat

In September 2021, the government announced an ambitious new plan to address the continued shortfall in housing supply. In the second quarter of 2021 housing completions recovered from the subdued levels in the first quarter as the construction sector re-opened further (see Graph 2.7). The number of housing commencements has sharply increased and in the second quarter of 2021 stood well above the 2019 average. Nonetheless, the gap between supply and demand is expected to remain wide in the short term, with the government estimating net additional housing needs to be around 33 000 annually to 2030 ([7])– substantially above the approximately 21 000 homes completed in 2019. To better meet these housing needs the government announced an ambitious 'Housing for All' plan in September, dedicating more than EUR 20 billion to funding for housing over the next 5 years. The plan aims to deliver an average of 33 000 new homes each year from 2021 to 2030, of which more than 10 000 would be new social homes and 6 000 new affordable purchase and cost rental homes ([8]). To reach these ambitious targets, effective implementation will be essential – particularly in light of potential capacity constraints in a range of housing-related sectors, including the estimated need to expand the construction sector's workforce from 40 000 to 67 500 full-time equivalent workers by the middle of the decade ([9]).

House prices in Ireland accelerated in the first half of 2021, reflecting the continued supply shortfall. After modest price decreases between July and October 2020, residential property prices started picking up again in the final months of 2020 and continued to accelerate in 2021 (see Graph 2.7). In August 2021, residential property prices were up by 10.9% y-o-y, with fairly similar price increases registered inside and outside Dublin. Following these increases, the national residential property price index stood 8.9% below its 2007 peak.

Graph 2.7: **Housing developments**



Source: CSO, Eurostat, Department of Housing

([7]) Government of Ireland (2021) Housing for All: A new Housing Plan for Ireland, p. 31.

([8]) Cost rental is a new form of public housing in Ireland, aimed at people who are above the social housing income limits. Rents charged will only cover the cost of developing, financing, managing and maintaining the homes – with a target to achieve rents of at least 25% below market level.

([9]) Government of Ireland (2021) Housing for All: A new Housing Plan for Ireland, p. 94.

Rental price growth accelerated and returned to pre-pandemic levels as a temporary increase in rental supply reversed. At the height of the pandemic, a lack of international tourism led landlords to switch from short-term letting platforms like AirBnB to regular renting. As a result, rental supply was up 64% y-o-y in Dublin in February 2021, putting downward pressure on rental prices. Furthermore, emergency government legislation banned evictions and rent increases for tenants financially impacted by COVID-19 from 31 December 2020 to 15 April 2021. However, following the general re-opening of the economy, this trend reversed and by September 2021 rental supply and rental price growth in Dublin had returned to pre-pandemic levels ([10]). Outside of Dublin rental stock available on the market continued to dwindle, to almost half of pre-pandemic levels in the second quarter of 2021 — in part due to increased opportunities for tenants to work remotely. An alternative rent index from the Residential Tenancies Board (RTB) suggests yearly price inflation in Q2 2021 was 2.5 times higher outside of Dublin than in the capital (10.4% and 4.4% respectively) ([11]).

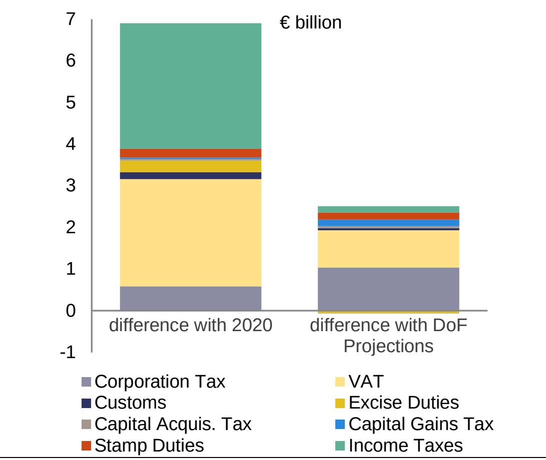
The outlook for commercial real estate is somewhat negative but shows considerable differences across segments. The industrial and logistics segments demonstrated strong resilience throughout the pandemic, in line with the strong performance of multinationals. In these segments investment in new construction continued to show strong momentum as demand remained high ([12]). The office segment of the market held up relatively well, even as the introduction of teleworking arrangements decreased demand for new office space. The Dublin office vacancy rate — although nearly doubling in 2020 to over 9% ([13])— remained considerably below the levels of the financial crisis partly due to the considerable pre-pandemic demand and constrained supply. Following the general re-opening of the economy, the office vacancy rate began to fall in the second quarter of 2021 ([14]). The retail sector was hit hardest by the pandemic restrictions and experienced large declines in terms of capital values and rents, although a negative trend was already emerging prior to the pandemic.

2.2. PUBLIC FINANCES

Public support to counteract the social and economic impact of the pandemic increased the government deficit in 2020 and 2021. For the first half of 2021, the government recorded a deficit of -4.4% of GDP, compared with -5.5% the same period last year and -4.9% for 2020 as a whole. A recovery of private consumption and business activity helped reduce the deficit. General government revenue in the first half of 2021 increased by 12.9% y-o-y, with a positive performance of direct taxes (12.7% y-o-y) – which include corporate and income tax – and VAT (42.6% y-o-y) revenues. At the same time, government expenditure increased by 8.6% compared with the first half of 2020, with expenditure related to COVID-19 measures expanding by approximately one-third compared to the first half of 2020. The support measures are expected to be wound down to a large extent by the end of 2021. According to the Commission 2021 autumn forecast, the general government balance is expected to post a deficit of 3.2% of GDP in 2021 and improve in 2022 and 2023, to 1.7% and 0.3%, respectively. This compares to deficits of 3.1% in 2021, 1.8% in 2022 and 0.2% in 2023, projected by the authorities in Budget 2022.

([10]) DAFT (2021) Irish Rental Report Q2 2021.
([11]) RTB (2021) RTB Rent Index Q2 2021.
([12]) CBRE (2021) Dublin Industrial and Logistics Market View Q2 2021.
([13]) CBI (2021) COVID-19 and the commercial real estate market in Ireland.
([14]) CBRE (2021) Dublin Office Marketview Q2 2021.

Graph 2.8: **Difference between tax receipts outturn, DoF projections and 2020 outturn (cumulative to end September)**

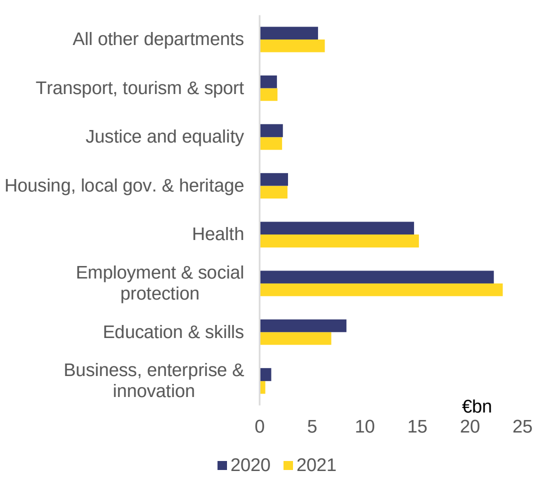


The department of finance projections were published in the May fiscal monitor.
Source: Department of Finance (DoF)

In September 2021, the Exchequer balance showed a smaller deficit than the year before on a 12-month rolling basis. Tax receipts rose markedly by 15.2% y-o-y. While the recovery was broad-based, it is worth noting the continuous increase in corporate income tax receipts – 14% ahead of government projections (see Graph 2.8) – and the recovery in value added tax and personal income tax collections, which grew at 25.9% and 18.9% y-o-y, respectively, as the economy reopened (see Graph 2.9). In addition, EUR 1 billion in transfers by the National Asset Management Agency (NAMA) to the Exchequer is planned for 2021. As of June 2021, NAMA had transferred EUR 0.5 billion, leading to a total of 2.5 billion since July 2020, which improved the fiscal balance. Total expenditure increased by 2.3% y-o-y in the first 9 months of 2021, driven by an increase in the contribution to the EU budget ([15]). Health, and employment and social protection spending showed the largest rise over the same period (see Graph 2.9). The overall spending outturn was nonetheless below government projections, by 3%.

The pandemic pressures on public spending are expected to weigh on the stock of public debt in 2021 but are likely to ease as of 2022. According to the Commission 2021 autumn forecast, the gross general government debt-to-GDP ratio is projected to reach 55.6% in 2021 and to fall to 52.3% and 51.1% in 2022 and 2023. These developments are to be seen in the context of strong nominal GDP growth of 14.3% projected for 2021, followed by 7.2% and 5.5% for 2022 and 2023. According to the Irish authorities, in GNI* ([16]) terms – a metric to relate the debt burden to the size of the domestic economy – the public debt ratio is forecasted to reach 106.2% in 2021, from 104.7% in 2020, and to decrease to 99.2% in 2022, and further to 96.7% by 2023.

Graph 2.9: **Exchequer expenditure cumulative till end-September**



Source: Department of Finance, Fiscal Monitors

Risks to the fiscal outlook are tilted to the downside. Public support related to COVID-19 is expected to be reduced as of 2022. However, uncertainty remains around the future evolution of the pandemic in the short term, and the potential need for fiscal measures to counteract its negative impact. Future changes to the international corporate tax framework might affect this important source of revenue as of 2023. Risks related to the take-up of contingent liabilities are limited. Concerns persist about medium-term debt

([15]) Imports from the UK are subject to tariffs given that the UK is no longer part of the European Union. Three-quarters of any additional revenue arising from this source is automatically allocated to the EU budget.

([16]) Modified Gross National Income (GNI*) reflects the income standards of Irish residents more accurately than GDP. It differs from actual GNI in that it excludes, for example, the depreciation of foreign-owned, but Irish resident, capital assets (notably intellectual property and assets associated with aircraft for leasing) and the undistributed profits of firms that have re-domiciled to Ireland.

sustainability due to the increasing cost of ageing (see Annex 1).

2.3. FINANCIAL SECTOR

The Irish financial sector withstood well the pandemic and was able to cushion the shock to the wider economy. Banks were able to maintain stable capital levels, while making further progress in reducing non-performing loans (NPLs). This shows clearly that the efforts of the past years to enhance the resilience of the financial sector have paid off. However, the fallout of the pandemic is not yet fully visible, as some companies that have relied on state support may have seen their debt levels increase, which could lead to credit-related losses for banks in the future. Profitability remains a major challenge for the five Irish retail banks, and a low return on capital, driven - among others – by high operating costs, has led some international banks to announce their intention to withdraw from the Irish retail market ([17]). The supervisors are monitoring these developments. Ireland is also home to a big, internationally oriented non-bank financial sector with important and growing linkages to the domestic market. The presence of financial technology companies creates opportunities for consumer choice, competition, and cost savings, but also risks, as they may draw business away from the incumbent banks and erode their profit opportunities.

Irish banks have maintained solid capital levels during the pandemic, even though the 2021 European Banking Authority (EBA) stress test highlighted some material vulnerabilities. The CET1 ratio of the five retail banks remained stable at 18.2% in the first half of 2021. Tier 2 capital issuance contributed to an uptick of the total capital ratio (TCR) by 50bps to 22.7%, which is high compared to other European banks (19.3% for significant banks within the Single Supervisory Mechanism, see Table 2.1). This is also due to the relatively high Pillar 2 Requirements that Irish retail Significant Institutions (SI) are facing ([18]). On a fully loaded basis, both CET1 and TCR are correspondingly 180bps lower than the mentioned phased-in levels. As a result of the higher credit loss experience, and difficulties enforcing collateral in Ireland, banks' internal risk models attach elevated risk weights to Irish mortgages, leading to a high risk weighted asset density compared to most other European countries, and consequently increasing their cost of capital. This is further compounded by the difficulties enforcing collateral in Ireland ([19]). High capital requirements have also likely played a role in the decision by two foreign-owned banks to announce their intention to withdraw from the Irish market. Going forward, the EBA stress test results depict Irish banks among those with the largest projected capital depletion over a three-year stressed scenario. This reflects their heavy exposures to credit risk, translating into larger impairments, and to their strong reliance on interest income in an environment of persistently low interest rates.

Liquidity buffers remain ample in the Irish banking system, well in excess of regulatory requirements. Irish households accumulated savings during the pandemic as consumption was restricted by lockdown measures, leading to strong deposit growth (+20.2% since end-2019, to a total of EUR 414.1 billion in March 2021) ([20]). Monetary policy measures further contributed to the abundant liquidity. Due to its attractive conditions, participation in targeted longer-term refinancing operations by Irish banks has increased recently and now accounts for EUR 24.1 billion, or 1.1% of the total borrowing from the Eurosystem (as compared to a peak of EUR 132 billion, or 24.1% in 2011 and the low point in September 2020, when Irish banks borrowed EUR 3.2 billion, or 0.2% of the Eurosystem total). Consequently, in June 2021, the net stable funding ratio and liquidity coverage ratio of Irish retail banks were at 145% and 199% respectively, 16bps and 47bps higher than at end-2019. Given the weak demand for loans, most of this liquidity is held in cash or

([17]) The five retail banks are Bank of Ireland, AIB Group, Permanent TSB, Ulster Bank Ireland, and KBC Ireland, together comprising about 45% of bank capital allocated in the Republic. Given the significance of the retail banking sector for the Irish domestic economy, in particular SME financing, they are the main focus of this analysis.

([18]) Pillar 2 requirements for Irish banks also above average in the euro area, see https://www.bankingsupervision.europa.eu/banking/srep/html/p2r.en.html

([19]) EBA (2020) Report on the benchmarking of national loan enforcement frameworks.

([20]) This refers to the full banking sector including CB funding and interbank deposits.

Table 2.1: **Financial soundness indicators, all domestic and foreign banks in Ireland**

in %	Ireland Q4-2017	Q4-2018	Q4-2019	Q1-2020	Q2-2020	Q3-2020	Q4-2020	Q1-2021	Euro area Q1-2021	EU Q1-2021
Non-performing loans	9.9	5.5	3.4	3.1	3.5	3.5	3.4	3.1	2.4	2.4
o/w foreign entities	7.1	-	-	-	-	-	-	-	-	-
o/w NFC & HH sectors	14.1	8.2	5.6	5.3	6.0	6.3	-	-	-	-
o/w NFC sector	11.8	5.7	3.2	3.1	4.5	5.3	6.2	6.3	4.7	4.6
o/w HH sector	15.5	10.1	7.2	6.9	7.1	7.0	6.8	6.3	2.9	2.9
Coverage ratio	29.9	28.5	27.5	27.9	29.7	28.8	30.2	28.3	46.3	46.1
Return on equity(1)	5.0	4.9	3.7	-0.3	-5.4	-3.0	-2.2	3.8	7.1	7.3
Return on assets(1)	0.7	0.7	0.5	0.0	-0.7	-0.4	-0.3	0.4	0.5	0.5
Total capital ratio	25.2	25.4	24.9	24.7	25.2	25.7	25.4	25.6	19.1	19.3
CET 1 ratio	22.9	22.9	22.3	22.2	22.4	22.6	22.3	22.4	15.8	15.9
Tier 1 ratio	23.4	23.4	23.0	22.9	23.4	23.7	23.3	23.5	16.8	17.0
Loan to deposit ratio	95.3	90.2	91.5	90.3	84.7	82.1	83.9	81.2	84.8	87.9

(1) For comparability reasons, annualised values are presented.
Source: ECB - Consolidated Banking data; own calculations

central bank deposits. However, due to the prevailing negative interest rate environment, these large stocks of cash and other liquid assets represent a cost for banks, which are now trying to recuperate some of the costs from their customers without weakening too much their deposit base. Some banks have already begun to charge negative interest rates to large depositors.

The banking sector returned to profitability in the first half of 2021 despite ongoing challenges. The current environment of negative interest rates and excess liquidity, combined with limited demand for loans and high operating costs, keeps weighing on banks' profitability. Banks recorded a loss for 2020, driven by sharp increases in impairment charges combined with lower operating income. Return on equity (RoE) for the sector was -2.2% in 2020. The amount of impairment charges declined significantly in 2021 and in some cases impairment losses have even been written back, contributing to yielding a RoE of 3.8% (annualised) in the first quarter of 2021 (Table 2.1). For the subgroup of the five retail banks, return on assets and RoE were at 0.4% and 4.0% respectively, in the first half of 2021, below the European averages of 0.48% and 7.6%, respectively. Retail banks continue addressing their over-reliance on interest income, which stands at 80% of total income, looking to increase trading activities and revenues from fees and commissions. On the cost side, banks keep striving for a reduction in costs, including through branch closures, and a stronger digital presence. Financial technology companies are still relatively small players in Ireland, not yet powerful enough to exert significant impact on the market structure. Going forward, their increasing presence is expected to further stimulate technological advances in the financial sector, helping profitability, but also to create competition for traditional banks.

Irish banks continued to reduce NPLs, extending the trend of the past years. The reductions were achieved by a mix of restructurings, sales and securitisation, as well as curing of certain exposures to performing loans. In June 2021, Irish retail banks reported an NPL ratio of 4.4%, representing a stock of EUR 11.8 billion, down from 5.5% in 2020 Q3 and even below pre-pandemic levels (5.2% in 2020 Q1). The share of NPLs related to mortgages decreased to 56%, leading to a better diversification of the NPL portfolio. After subdued activity in 2020, the market for NPLs picked up in 2021, driven by renewed investor appetite and banking consolidation in Ireland. Despite these positive developments there are concerns about the weak enforceability of collateral, which leads to high loss-given-default estimates and therefore contributes to higher interest rates on new lending. The gross recovery rate is much lower compared to other EU Member States ([21]).

The pandemic led to an increase in banks' risky credit exposures. By June 2021, Irish retail banks had provided payment breaks on EUR 23.5 billion of loans. Almost all payment breaks had expired by the end of 2020, with less than EUR 0.2 billion

([21]) EBA (2020) Report on the benchmarking of national loan enforcement frameworks.

in loan balances remaining under a payment break at the end of June 2021 ([22]). The expiry of payment moratoria has so far not affected NPL ratios, but the staging profile of the retail banks' loan portfolios has changed significantly since the beginning of the pandemic. While an increase in stage 3 loans has been offset by NPL sales, stage 2 exposures have increased significantly. In the second quarter of 2021, 16.7% of all loans were classified as stage 2 compared to 8.4% at end-2019.

The mortgage segment saw a more favourable development than SME loans during the pandemic. Thanks to government income support, households were largely able to continue repaying their mortgages, even in the case of unemployment. The forbearance ratio of expired moratoria for household loans for primary residences stood at 15% at the end of June 2021, and 34% of such loans were classified as stage 2. This was lower in comparison to the segment of business loans. Companies were severely impacted by the lockdown measures and many had to cease operations. The Irish central bank estimates that 70% of SMEs were not profitable in 2020. Payment breaks were approved for 24.6% of exposures to SMEs and, by June 2021, 31% of SME loans for which moratoria had expired were under forbearance while 62% were classified as stage 2. In the whole population of SME loans, 39% are currently classified as stage 2. For other corporates, only 10.3% received a payment break, but loans with expired moratoria showed a slightly worse performance than SMEs, with 42% of them in forbearances and 71% classified at stage 2 ([23]).

Meanwhile, lending to households has almost recovered to pre-pandemic levels, while lending to small businesses remains sluggish. The pandemic interrupted the upward trend in mortgage lending, but by mid-2021 lending to households and businesses had recovered. In the first half of 2021, new lending for house purchases was just 4.0% below the level of the same period in 2019, up by 18.0% on the same period in 2020. However, lending to small businesses is lagging as companies are hesitant to invest in the current uncertain environment. In the first half of 2021, new lending to SMEs was 19.3% below the corresponding level of 2019, despite a rise by 14.9% over 2020. While banks tightened their lending standards for SME loans somewhat, it is likely that demand factors played a dominant role in the reduction of lending to SMEs.

Outside the retail segment, Ireland also benefits from the presence of large investment banks. Their clients are mainly large multinational corporations across the EU, whom they serve from their Irish base. The sector has grown significantly over the past years, as those institutions looked for a new EU footing after the UK left the EU. The combined assets of three main investment banks (Bank of America, Barclays and Citi) grew to EUR 250 billion by end 2020 from EUR 32 billion at year-end 2015. While these banks provide important financial services to global corporations as well as to the Irish financial sector, such as hedging, trading, custody, treasury and payment services, they are less directly exposed to economic developments in Ireland as their lending activity is focused on large corporates outside of Ireland. Also the payment moratoria, geared towards small businesses and households, were less relevant for them. Their corporate clients tend to have access to capital markets and are therefore less dependent on bank credit. Investment banks based in Ireland have a very low NPL ratio of 1.1%.

The withdrawal of two foreign-owned banks from the Irish market will lead to a major reallocation of market shares among the three remaining retail banks. Following the announcements made by Ulster Bank Ireland DAC (UBI) and KBC Ireland plc (KBCI) to leave the Irish market, the three remaining retail banks have provisionally agreed on purchases of KBC Ireland's and UBI's performing assets ([24]). Specifically, Allied Irish Banks plc (AIB) has agreed to buy UBI's EUR 4.2 billion corporate and commercial performing loans and to take over approximately 280 employees. Meanwhile, Bank of Ireland signed a non-binding memorandum of understanding (MoU) with KBCI to potentially purchase its performing loan assets and deposit liabilities. Permanent TSB has entered into a non-

([22]) These numbers refer to the five retail banks. For the entire banking system, payment breaks peaked at approximately EUR 27 billion.

([23]) The figures in this paragraph exclude exposures identified as Commercial Real Estate (for both SME and Corporates).

([24]) These agreements remain subject to the approval of the Competition and Consumer Protection Commission.

binding MoU with NatWest Group plc and UBI to purchase an approximate EUR 6.5 billion portfolio that comprises the performing non-tracker mortgage loans of UBI, the asset finance business and, notably, the micro loan portfolio. This deal may also include a transfer of employees and certain branches. PTSB, until now acting primarily as a mortgage lender, is thus venturing more substantially into the field of small business loans. An additional bank serving this market should be beneficial for the banking sector as a whole, for competition between banks and more specifically for small business customers. In this respect, interest rates on business loans in Ireland are at present among the highest in the euro area. The two banks withdrawing from Ireland are actively looking for buyers of their non-performing loan portfolio.

Ireland is home to a rapidly expanding market-based financial sector that is assuming ever greater importance for the Irish economy. The Irish central bank estimates the size of this sector at EUR 5.6 trillion in assets at end 2020. The sector is composed of a diverse set of institutions such as investment and money market funds, securitisation and non-securitisation vehicles, as well as other financial institutions. The vast majority of the funds mentioned invest in international assets, with only a small number, in particular real estate funds, investing in the Irish economy. However, they are significant investors in some markets. For instance, Irish property funds account for more than 40% of the estimated stock of investable commercial real estate in the country. A study by the Central Bank of Ireland (CBI) found a significant level of leverage and a less significant level of liquidity mismatch in some of these funds ([25]). This could pose a threat if some of the funds have to sell part of their assets over a relatively short period of time. During the selloff in early 2020, most Irish investment funds were able to meet their redemption requirements, albeit with the help of the central bank intervention. The Irish supervisors and the central bank are constantly monitoring the funds sector and are working to improve the regulatory tools to manage liquidity and leverage risks in the sector.

Non-bank lenders are playing an increasingly important role as financing providers to several sectors of the economy. They tend to specialise in the types of customers they serve and the product lines they offer, with an especially strong position in real estate development finance, as traditional banks have been retreating from this field since the financial crisis. SMEs are important customers, and in 2019-2020 non-bank financial providers lent EUR 1.8 billion to SMEs in the real estate and construction sector, about 40% of the total. The rise of non-bank lenders poses some risks that require careful monitoring. Where lending occurs through a special purpose vehicle (SPV), equity funding is typically minimal, less than 0.1% of total financing, with profit participating notes/loans taking equities position in the funding structure alongside senior debt. Equity funding is more common in other non-bank lending structures. Overall, Irish SMEs owed non-bank lenders EUR 4.3 billion at end-2020 compared to EUR 19.8 billion owed to banks.

Ireland's financial sector has played a favourable role during the crisis caused by the global pandemic. It confirmed its ability to act as a shock absorber during difficult months, which is a clear sign that the efforts of the past decade to make the Irish banking system more resilient have paid off. Admittedly, this would not have been possible without the exceptional support by central banks and governments across the world, in the form of liquidity measures and the substitution of lost household and corporate income. These global supportive measures were a prerequisite for the financial system to continue functioning and they helped achieve a much more benign outcome of the latest crisis compared to what could have been expected. Moreover, the presence of large multinational companies, in particular pharmaceutical and technology companies, proved to be particularly beneficial for Ireland, as it boosted the domestic economy, which in turn limited credit losses to the banks. Risks remain visible, however, and will require monitoring and remedial action going forward in order to ensure that the significant achievements made since the global financial crisis will be maintained.

([25]) Central Bank of Ireland "Property funds and the Irish commercial real estate market" Financial Stability Notes Vol 2021, No 1.

3. POLICY ISSUES

3.1. PUBLIC FINANCES

Ireland took the necessary measures to combat the pandemic, shore up the economy and employment and support the recovery in domestic output. The fiscal costs of this response were significant, totalling EUR 13.4 billion in 2021 (3.4% of GDP or 6.0% of GNI*), EUR 2 billion lower than in 2020. Measures were focused on the expenditure side and directed to support employment, household income and the liquidity of businesses. By end-2022, public support is expected to be phased out as the economy fully reopens throughout the year. Most of the support measures will be in place until December 2021, while the PUP scheme is expected to end in February 2022 and the EWSS by April 2022. Nonetheless, the Irish government has budgeted a provision for COVID-19 related expenditure of approximately 1.7% of GDP in 2022. Moreover, in Budget 2022, Ireland announced plans to expand its healthcare capacity by increasing the allocated expenditure by about 0.2% of GDP. Other measures include a tax warehousing scheme, which was extended until December 2021 under the *Economic and Recovery Plan*. Since the beginning of the pandemic, a total of EUR 2.7 billion in taxes have been warehoused for repayment on 2023.

Loans and contingent support measures are also being phased down. The COVID-19 Credit Guarantee Scheme provided EUR 2 billion in public guarantees – of which slightly less than 500 million were taken up by October 2021 – and is due to close in December 2021. In addition, to access European financing instruments a counter-guarantee was issued for the credit extended by the European Union under SURE; and a guarantee was issued from the EIB's Pan-European Guarantee.

The sustainability challenges to the pension system persist. A potential increase in the pension age, currently set at 66 years, was suspended. Although the current age structure is favourable, Ireland's old-age dependency ratio – which expresses the number of retirees as a fraction of the total number of workers – is set to nearly-double over the next 30 years in a no-policy change scenario, from the current 24% to 47% by 2050 ([26]). These developments may have an impact on future pension-related expenditure and constitute a risk to the sustainability of Ireland's public finances in the medium term.

The Irish government has set out a medium-term anchor for the budgetary policy framework. The framework is based on capping overall expenditure growth at the rate of trend growth of the economy, i.e. at 5%. It is estimated that expenditure related with the provision of existing public services (public service pay deals; demographics; healthcare) will increase at an annual pace of about 3%. In addition, the legacy of pandemic public support and future increases in capital expenditure due to housing and climate objectives put further pressure on the debt ratio. In this context, the Irish government defined a medium-term budgetary anchor, adopted for the Budget 2022, by defining departmental expenditure ceilings growing by 5% per year, an estimate based on past trend growth developments, with the pandemic support being withdrawn on a phased basis ([27]). Estimates of potential growth are surrounded by a considerable degree of uncertainty in the case of Ireland, given its dual economy and historically large fluctuations around trend growth.

Changes to the international corporate tax framework may shift the tax composition. Corporate income tax revenues proved resilient to the pandemic but are highly concentrated in predominantly multinational-controlled sectors (such as ICT and pharmaceuticals) and are characterised by high volatility. Over time they have become an increasingly important source of revenue for the Exchequer and in 2020 accounted for 20.7% of total Exchequer tax receipts, compared to a long-run average of about 13.5% between 1998 and 2015. The Irish authorities estimate that future changes in the international corporate tax framework will reduce the level of corporate tax receipts permanently by EUR 2 billion annually ([28]). Nevertheless, this estimate is subject to considerable uncertainty. The Irish economy continues to show

([26]) Department of Finance, September 2021, Population Ageing and the Public Finances in Ireland,.

([27]) Summer Economic Statement, July 2021, Department of Finance and Public Expenditure Reform, Government of Ireland.

([28]) Summer Economic Statement, July 2021, Department of Finance and Public Expenditure Reform, Government of Ireland.

many comparative advantages in attracting foreign direct investment due to its high-quality labour force, geography and openness to global markets.

A broadening of the tax base remains crucial to improve the resilience of tax revenues. In June 2021, the Irish government introduced changes to the local property tax that contributed to the widening of the tax base ([29]). Broadening the tax base in a revenue-neutral manner and taking flanking measures in other tax categories could protect Irish public finances against potential fluctuations in, for example, corporate income tax receipts.

3.2. FINANCIAL SECTOR POLICIES

The Irish government provided several support schemes to Irish businesses and households, which also indirectly supported the stability of the financial sector. Wage subsidy schemes, namely the Employment Wage Subsidy Scheme and its predecessor the Temporary Wage Subsidy Scheme, as well as Pandemic Unemployment Payments, were the most significant ones, accounting together for a volume of EUR 17.5 billion by mid-October 2021. In addition to these measures there were numerous support schemes targeting businesses directly. The COVID-19 credit guarantee scheme registered approvals of EUR 518 million by mid-September 2021, while the COVID-19 working capital scheme was closed to new applications on 14 July 2021 after approvals reached EUR 128 million. The Future Growth Loan Scheme, not directly geared towards the pandemic, has seen EUR 725 million of approvals. Apart from these bigger schemes, the government has made a number of smaller schemes available to Irish businesses.

As government support measures are being phased out and the economy is moving towards a 'new normal', supervisors and authorities need to remain vigilant about remaining and potential emerging instabilities. Insolvency notifications remained at an unusually low level in 2021 to date, despite elevated estimates of financial distress among SMEs. The CBI expects higher stress levels to remain in place for a few years in some sectors, in particular hospitality, transport, wholesale and retail trade. On the positive side, new company registrations have rebounded.

Macroprudential measures have supported the resilience of the financial system and continue to do so. The CBI has maintained the countercyclical capital buffer (CCyB) at zero since lowering it in March 2020 from the previous 1%, in order to help the banking system absorb the negative impact of the COVID-19 crisis. The CBI has stated that it does not expect a change in the rate in 2021, as credit demand continues to be subdued and the economic situation remains uncertain. However, it has emphasised the importance of setting a positive buffer sufficiently early in the cycle so that enough capital can be accumulated ahead of another stress period. The central bank also stressed that the O-SII continued to be available to absorb the impact of the pandemic, and that the Systemic Risk Buffer (SyRB) will not be phased in in 2021.

The Irish central bank is proceeding with its 2021 review of the mortgage measures and has launched a review of the overall macroprudential framework. The annual review includes an assessment of recent housing and mortgage market developments and assesses the measures against their current objectives. House prices in 2021 grew faster than average household incomes. A recent feature of the market is the increasing role of property investors not reliant on mortgages, which are thus not in the scope of the mortgage measures. The framework review is a multi-year programme of work with three pillars: banks, borrowers (mortgage measures), and non-banks. The review of the mortgage measures framework will revisit the objectives of the policies, assess the effectiveness of the available instruments and review their calibration strategy.

The expansion of the non-bank financial sector provides opportunities as well as challenges that require careful consideration. Fintechs typically operate in niche markets and can thus avoid much of the legal and regulatory burden of full-service, licensed banks. The national regulators are working closely with the European institutions to assess carefully the available policy options and to strike a balance between enabling innovation and technological progress to unfold for the benefit of consumers' choice and efficiency, while at the same time safeguarding the stability of the financial system and preventing new imbalances from emerging.

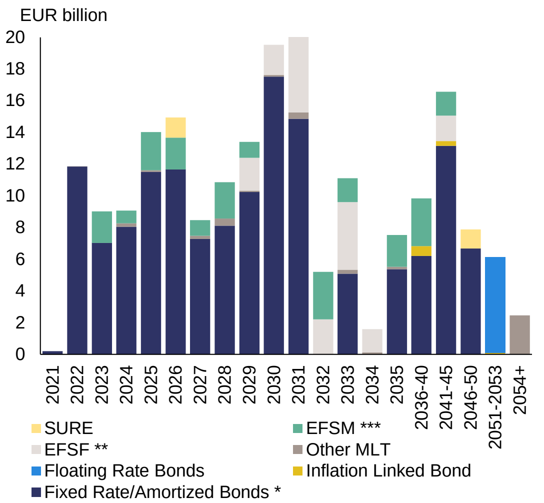
([29]) Finance (Local Property Tax) (Amendment) Act 2021

4. SOVEREIGN FINANCING ISSUES

The government funding strategy is driven by a prudent approach. The National Treasury Management Agency (NTMA) issued EUR 16 billion in long-term bonds in the first 9 months of 2021 ([30]), at an average maturity above 14 years and a weighted average yield of 0.14%. A strong cash position of over EUR 20 billion is expected by the end of 2021. There are two long-term bond maturities in 2022.

Sovereign borrowing continues enjoying favourable market financing conditions despite an uptick in yields since early 2021. The 10-year bond yield for Ireland continues to be close to zero, and recent increases have been in line with moves in other countries. The spread against the German benchmark has stabilised close to pre-crisis levels after a peak in mid-March 2020. The Irish sovereign credit ratings outlook have been upgraded from stable to positive by DBRS and Moody's in July and August 2021 respectively. Interest expenditure in Ireland is expected to have fallen to 0.8% of GDP in 2021 from to 1.0% in 2020, and to fall further to 0.7% in 2022. As a share of GNI*, interest expenditure are projected at 1.5% in 2021 and 1.4% in 2022. A re-calibration of monetary policy, with the potential withdrawal of measures like the ECB's pandemic emergency purchase programme would not have a significant impact on Ireland's interest bill in the coming years. A strong cash position combined with a portfolio mostly consisting of fixed-rate debt with long maturity, is expected to cushion a future increase in interest rates. Interest expenditures projected for 2022 are similar to 2021.

Graph 4.1: **Maturity profile of medium- and long-term marketable and official debt (end-September 2021)**



The Irish programme was the second euro area assistance programme, and the first financed by two new financial assistance instruments established in 2010, the EFSF and the EFSM.
* Includes NTMA Repo activity.
** EFSF loans reflect the maturity extensions agreed in June 2013.
*** EFSM loans are also subject to extension, such that their original aggregated weighted average maturity will be a maximum of 19.5 years. However the revised maturity dates of individual EFSM loans will only be determined as they approach their original maturity dates. The table and graph above reflect both original and revised maturity dates of individual EFSM loans.
Source: NTMA

Risks for Ireland's capacity to service EFSM and EFSF debt remain low. Ireland will not have to repay any of its EFSF and EFSM loans before 2023 ([31]).

([30]) Excluding funds raised in non-competitive bond auctions.

([31]) The maturity of EFSM loans to Ireland can be extended, to a weighted maximum of 19.5 years.

Table 4.1: **Government financing plans**

EUR billion	2020	2021
Funding requirement		
Exchequer borrowing requirement (EBR) (1)	12.3	12.1
Bond maturities	17.1	0.0
Net short-term paper	0.0	4.4
UK bilateral loan	1.9	0.5
Other (2)	1.8	4.4
Total requirement	***33.1***	***21.5***
Funding sources		
Government bonds (3)	25.5	20.1
SURE Programme	0.0	2.5
Net short-term paper	4.1	0.0
Other (4)	4.4	2.5
Use of cash (- represents an increase)	-0.9	-3.7
Total sources	***33.1***	***21.5***
Financial buffer (5)	**17.4**	**21.0**

Rounding may affect totals. 2021 figures are estimates, as of October 2021.
(1) 2021 estimate as per Department of Finance, Budget 2022 (October 2021).
(2) Includes floating-rate note purchases, and for 2021 general contingencies, including for potential bond purchases.
(3) 2020 reflects cash proceeds from syndications and auctions, including non-competitive auctions. The NTMA's bond funding range for 2021 was narrowed to EUR 18-EUR 20bn following the release of the government's Summer Economic Statement in July. While EUR 19bn nominal - the mid point of the range - is reflected in this table, it also includes the cash proceeds of syndications and auctions, including non-competitive auctions, to end-September.
(4) This category is mostly comprised of net State Savings (Retail), and other medium/long-term borrowing.
(5) Exchequer cash; excludes other non-liquid Exchequer financial assets.

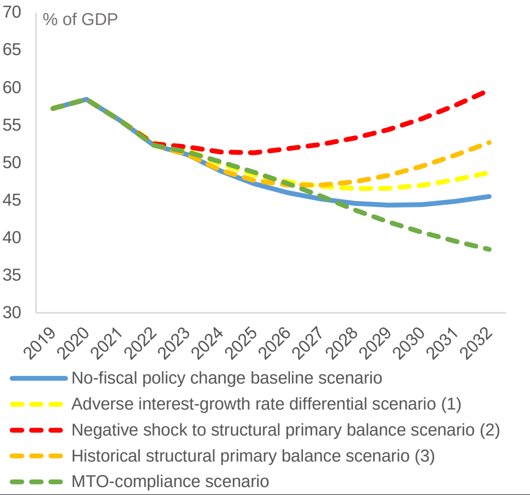
Source: NTMA

The profile of government debt is favourable. The weighted average maturity was lengthened between 2015 and 2021 to take advantage of quantitative easing programmes. Interest payments are expected to remain stable in the short term in absolute terms, hence decreasing as a percentage of revenues. As of Q1-2021, 'sticky' sources — such as official loans, Eurosystem bond holdings, and domestic retail holding — accounted for over 55% of Irish government debt.

ANNEX 1
Debt sustainability analysis

The debt sustainability risks of Ireland appear contained over the short and the medium term. Public debt relative to GDP is forecast to have peaked in 2020. According to the debt sustainability analysis the ratio is projected to decline in 2021 and the years after – initially driven by the recovery of the economy and a phased unwinding of the government response to the COVID-19 crisis. In the baseline scenario the debt ratio is then expected to follow a declining trajectory before slightly rising between 2030 and 2032 due to an increase in projected ageing costs and a less favourable snowball effect ([32]) (See Graph A1.1). Noteworthy, the baseline projections revert to a standard 'no-fiscal policy change' scenario, which assumes that the government primary balance (in structural terms and before ageing costs) remains constant at its last forecast value (2023) for the remainder of the 10-year projections. In contrast, in previous reports, since the autumn 2020, the standard baseline fiscal assumption had been adjusted in light of the unprecedented impact of the COVID-19 crisis, also on the structural primary balance. ([33]) The assumptions on real GDP growth continue to build on the latest short-term Commission forecast for the years 2021-2023. For the period 2024-2032 the projections now include the expected growth impact of NextGeneration EU, including the investments under the Recovery and Resilience Facility based on the Commission's standard T+10 simulations adjusted on the basis of the QUEST model ([34]). This simulation is carried out simultaneously for all Member States, hence it also includes spill-over effects. Inflation assumptions beyond the short term build on market expectations measured by the '10-year 10-year' inflation-linked swaps ([35]) until the tenth forecast year, hence they are consistent with the market expectations on sovereign financing costs.

Graph A1.1: **Public debt projections under different scenarios**



(1) This scenario assumes simultaneous shocks to (short and long-term) market interest rates and economic growth, similarly to a combined adverse shock to these variables.
(2) This scenario assumes the structural primary balance to fall by half of the baseline cumulative change in 2022 and 2023 and then stay constant at this lower level over the remaining projection period till 2032. This scenario incorporates a feedback effect on GDP growth whereby a fiscal expansion of a 1 pp. of GDP impacts positively baseline GDP growth by 0.75 pp in the same year.
(3) This scenario assumes convergence of the structural primary balance to its historical average in 4 years (historical average over the period 2005-19).
Source: European Commission

However, an 'adverse interest-growth rate differential' scenario – whereby that differential would be assumed to increase by 1 percentage point by applying simultaneous unfavourable shocks to (short and long-term) market interest rates and GDP growth – would add about 3 percentage points to the debt ratio

([32]) Snowball effects refer to the net impact of the counteracting effects of interest rates, inflation and real GDP growth on the evolution of the debt ratio.

([33]) In the previous reports, published since autumn 2020, rather than assuming a constant structural primary balance at its last forecast value, the baseline assumed a correction of fiscal positions over the medium term (i.e. the structural primary balance was set to converge back to its pre-crisis forecast value). This adjusted baseline aimed at accounting for the fact that the last forecast value (for year 2022) for the structural primary balance was strongly affected by the COVID-19 crisis, and by the temporary measures adopted as a response to the crisis, thereby providing an inadequate reference to set an assumption for the medium term fiscal position assumption. This is not the case anymore as the last forecast value now refers to the year 2023 in the Commission 2021 autumn forecast.

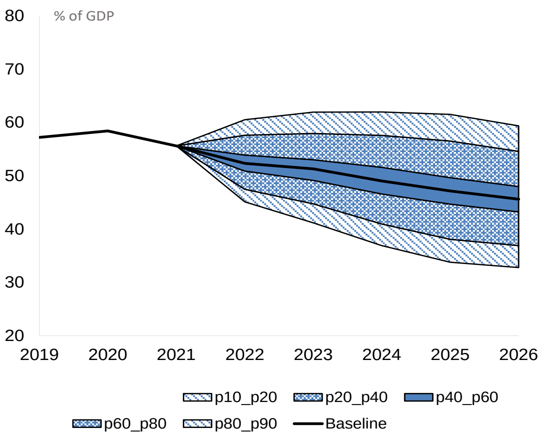
([34]) Simulations by the Commission services show that the recovery and resilience plan, together with the rest of measures of the European Union Recovery Instrument, has the potential to increase the GDP of Ireland by between 0.3% and 0.5% until 2026, not including the possible positive impact of structural reforms, which can be substantial. This, *ceteris paribus*, contributes to influence positively debt sustainability.

([35]) The 10-year forward swap rate 10 years ahead refers to the ten-year inflation expectations ten years from now.

by 2032. On the upside, the debt sustainability analysis does not factor in the implementation of the Irish government's commitment to a medium-term budgetary anchor by defining departmental expenditure ceilings growing by 5% per year, which would constrain public expenditure growth more than assumed in the baseline and adverse scenarios.

The robustness of these projections against plausible unforeseen events is high. Stochastic projections, taking into account a large range of possible temporary shocks to macroeconomic and fiscal variables, show the uncertainty surrounding the baseline scenario – measured by the difference between the 10th and 90th debt distribution percentiles – is moderate compared to the other EU Member States. (See Graph A1.2) ([36]).

Graph A1.2: **Stochastic projections for the public debt ratio in the period 2019-2026**



Source: European Commission

A number of factors mitigate sovereign debt sustainability risks in Ireland. At the end of the third quarter of 2021, the estimated weighted average maturity of the debt portfolio in Ireland was 11 years, which points to low rollover risks. The majority of gross national debt is at fixed rates. So-called "sticky" sources - official loans, Eurosystem, retail - make up over 55% of Irish debt ([37]). Furthermore, the implementation of growth-friendly reforms and investments under NextGeneration EU, notably the Recovery and Resilience Facility, is expected to yield a substantial positive and long-lasting impact on GDP growth in the coming years.

([36]) Stochastic debt projections allow assessing the uncertainty surrounding macroeconomic and fiscal projections. Projections have a 5-year projection horizon. Results are based on 80% of all possible debt paths obtained by simulating 2 000 shocks to the primary balance, nominal growth and interest rates (the lower and upper lines delimiting the cone represent respectively the 10th and the 90th distribution percentiles). In the chart, the projected debt path under the baseline (around which shocks apply) is reported as a solid black line at the centre of the cone. The differently shaded areas within the cone represent different portions of the distribution of possible debt paths. The dark blue area (delimited by the 40th and the 60th percentiles) includes the 20% of all possible debt paths that are closer to the baseline.

([37]) NTMA's October 2021 Investor Presentation

ANNEX 2

Supplementary tables

Table A2.1: **Fiscal accounts (based on Commission 2021 autumn forecast)**

	2020	2021	2022	2023
		% of GDP		
Indirect taxes	6.5	6.3	6.4	6.5
Direct taxes	10.1	10.1	9.6	9.6
Social contributions	4.0	3.8	3.6	3.6
Sales	1.1	1.0	0.8	0.7
Other current revenue	0.5	0.4	0.4	0.4
Total current revenue	**22.1**	**21.7**	**21.0**	**20.9**
Capital transfers received	0.3	0.3	0.3	0.4
Total revenue	**22.4**	**21.9**	**21.2**	**21.1**
Compensation of employees	6.6	6.0	5.8	5.8
Intermediate consumption	4.0	4.0	3.7	3.0
Social transfers in kind via market producers	1.9	1.7	1.4	1.3
Social transfers other than in kind	8.3	7.0	6.2	5.4
Interest paid	1.0	0.8	0.7	0.7
Subsidies	1.6	1.5	0.7	0.5
Other current expenditure	1.1	1.2	1.2	1.1
Total current expenditure	**24.5**	**22.1**	**19.7**	**17.9**
Gross fixed capital formation	2.4	2.2	2.5	2.8
Other capital expenditure	0.5	0.7	0.7	0.7
Total expenditure	**27.3**	**25.0**	**22.9**	**21.4**
General government balance	**-4.9**	**-3.2**	**-1.8**	**-0.4**
General government balance net of one-offs	**-4.9**	**-3.2**	**-1.8**	**-0.4**
		EUR billion		
Indirect taxes	24.2	26.9	29.2	31.1
Direct taxes	37.6	42.9	44.1	46.1
Social contributions	15.0	16.1	16.7	17.4
Sales	4.0	4.2	3.5	3.3
Other current revenue	1.8	1.8	1.8	2.0
Total current revenue	**82.6**	**91.9**	**95.2**	**99.9**
Capital transfers received	1.0	1.2	1.5	1.8
Total revenue	**83.6**	**93.1**	**96.7**	**101.7**
Compensation of employees	24.5	25.7	26.7	27.8
Intermediate consumption	14.9	17.0	16.9	14.6
Social transfers in kind via market producers	7.1	7.1	6.5	6.3
Social transfers other than in kind	31.0	29.8	28.2	25.9
Interest paid	3.8	3.2	3.4	3.6
Subsidies	6.1	6.2	3.0	2.5
Other current expenditure	4.0	5.3	5.3	5.5
Total current expenditure	**91.5**	**94.2**	**90.0**	**86.2**
Gross fixed capital formation	8.8	9.4	11.4	13.3
Other capital expenditure	1.7	2.8	3.1	3.6
Total expenditure	**102.0**	**106.6**	**105.1**	**103.6**
General government balance	**-18.4**	**-13.5**	**-8.4**	**-1.9**
General government balance net of one-offs	**-18.4**	**-13.5**	**-8.4**	**-1.9**

Source: Eurostat and European Commission

Table A2.2: **General government debt projections (based on Commission 2021 autumn forecast)**

	2020	2021	2022	2023
Real GDP growth (% change)	**5.9**	**14.6**	**5.1**	**4.1**
levels, EUR billion				
Government balance	**-18.4**	**-13.5**	**-8.4**	**-1.9**
Gross debt	217.9	236.9	239.5	247.2
Change in gross debt	13.9	19.0	2.6	7.7
Nominal GDP	372.9	426.1	456.7	482.0
Real GDP	353.8	405.3	426.0	443.4
% of GDP				
Government balance	**-4.9**	**-3.2**	**-1.8**	**-0.4**
Gross debt ratio	58.4	55.6	52.4	51.3
Change in gross debt	1.2	-2.8	-3.2	-1.2
contribution to change in gross debt				
Primary balance	-3.9	-2.4	-1.0	0.4
'Snow-ball' effect*	-1.5	-6.6	-2.9	-2.0
of which				
Interest expenditure	1.0	0.8	0.7	0.7
Real growth effect	-3.2	-7.4	-2.6	-2.0
Inflation effect	0.7	0.1	-1.0	-0.7
Stock-flow adjustments	**-1.2**	**1.3**	**-1.3**	**1.2**
Implicit interest rate	*1.9*	*1.5*	*1.4*	*1.5*

The projections assume no borrowing for precautionary contingencies envisaged in the programme's financing plan.
*The 'Snow-ball' effect, interest expenditure, real growth effect and inflation effect are derived from the Commission forecast analysis. Snow-ball effects refer to the net impact of the counteracting effects of interest rates, inflation and real GDP growth on the evolution of the debt ratio.
Source: Eurostat and European Commission

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