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Post-Programme Surveillance Report

Ireland, Autumn 2023

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This Post-Programme Surveillance assessment was prepared in the Directorate-General for Economic and Financial Affairs of the European Commission under the guidance of Declan Costello, Deputy Director General, Isabel Grilo, Director, and Robert Kuenzel, Deputy Head of Unit for Ireland ([1]).

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The report was prepared in liaison with staff from the ECB ([2]). Staff from the European Stability Mechanism (ESM) also provided comments.

This report reflects information available and policy developments that have taken place until 31 October 2023. Therefore, the macroeconomic and budgetary projections, including those underlying the debt sustainability analysis, are in line with the Commission 2023 autumn forecast released on 15 November (with a cut-off date of 31 October 2023).

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([1]) The executive summary of this report was adopted as Commission Communication C(2023)9800 on 19 December 2023. The rest of the report reflects the findings of the Staff Working Document (SWD(2023)980) accompanying this communication.

([2]) European Central Bank (ECB) staff participated in this mission, and 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

CBI	Central Bank of Ireland
CCyB	Countercyclical capital buffer
CET1	Common Equity Tier 1
CRE	Commercial Real Estate
CSO	Central Statistics Office Ireland
ECB	European Central Bank
EFSF	European Financial Stability Facility
EFSM	European Financial Stabilisation Mechanism
ESM	European Stability Mechanism
GDP	Gross Domestic Product
GNI*	Modified Gross National Income
HICP	Harmonised Index of Consumer Prices
ICT	Information and Communication Technology
MBF	Market-based financial sector
NBLs	Non-bank lenders'
NFCs	Non-Financial Corporations
NPL	Non-performing loan
NTMA	National Treasury Management Agency
O-SII	Other Systemically Important Institutions
PPS	Post-programme surveillance
q-o-q	Quarter-on-quarter
RoA	Return on Assets
RoE	Return on Equity
SME	Small and medium-sized enterprises
VAT	Value Added Tax
y-o-y	Year on year

EXECUTIVE SUMMARY

The 19th post-programme surveillance mission to Ireland took place from 20 to 22 September 2023. This 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.

The Irish economy slowed in the first half of 2023, a consequence of the weak performance of some multinationals. Private consumption remained stable in the first half of the year as total employment reached record highs. However, high inflation has led to a decline in real household disposable income and wealth, weighing on consumer sentiment and moderating private consumption growth. Headline investment declined year-on-year in the first half of 2023 and is expected to remain subdued as a result of tighter financial conditions and a more muted demand outlook. Sector-specific developments and a deteriorating global economic outlook, as well as geopolitical tensions, led to a fall in net exports in the first half of the year. However, recent large-scale investments by multinational corporations and a recovery in the global trade outlook is expected to support export activity in the upcoming years. Ireland's real gross domestic product (GDP) is expected to decline by 0.9% in 2023 and increase in 2024 and 2025 by 3.0% and 3.4% respectively. Modified domestic demand is expected to grow by 2.3% in 2023, 1.9% in 2024 and 2.1% in 2025. Inflation is also expected to ease.

The outlook for public finances is favourable, though fiscal-structural issues persist. Ireland is expected to achieve a general government surplus in 2023 of 0.6% of GDP. General government revenues are proving resilient; however, this outlook benefits from the high level of corporate tax receipts, a large share of which could be considered windfalls. Government expenditure is growing in line with expectations; however, there are delays in capital spending. Government debt is expected to decline relative to economic activity in the next few years. Long-term fiscal-structural issues persist, such as the need to broaden the tax base, as about one in three income earners is exempt from taxes.

The Irish financial sector remains resilient, with domestic banks improving their profitability as they benefited from a significant increase in net interest income. Irish retail banks improved their performance and made progress in absorbing the loan books and deposits from the two banks that are withdrawing from the Irish market. The market volatility observed in the first quarter of the year did not materially impact their deposit base and funding costs. Asset quality remains sound, with the sector's non-performing loan ratio stabilising at a low level, supported by improvements in the credit quality to the household sector. Despite these positive developments, risks in the banking sector remain tilted to the downside particularly with respect to credit risk on the back of a deteriorating macroeconomic outlook. Credit quality of non-financial corporate exposures has deteriorated compared with pre-pandemic levels, as credit risk has increased in some lending segments. In particular, the commercial real estate sector displays significant vulnerabilities. The large non-bank financial sector increased in size but continues to exhibit limited interlinkages with the Irish economy. The volume of lending of non-bank lenders has been negatively affected by their higher wholesale funding costs.

Ireland retains the capacity to service its debt. Despite a number of challenges, the economic, fiscal and financial situation in Ireland is sound overall. According to the debt sustainability analysis, Ireland is assessed to face low risks in the short and medium-term, while long-term risks appear to be medium. Government gross financing needs are low, on the back of projected primary surpluses. Repayments of the principal on EFSF loans will start in 2029 and the first EFSM maturity – of EUR 2 billion – was met in the fourth quarter of 2023. Ireland has a large cash buffer and continues to enjoy favourable financing conditions as its sovereign debt ratings are positive.

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1. INTRODUCTION

From 20 to 22 September 2023, staff from the European Commission, in liaison with staff from the European Central Bank (ECB), undertook the nineteenth post-programme surveillance (PPS) mission to Ireland. Staff from the European Stability Mechanism (ESM) participated in these meetings on aspects related to the ESM's Early Warning System. 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 missions is to assess the economic, fiscal and financial situation to ensure the Member State maintains its capacity to service its debt ([3]).

From 2011 until the end of 2013, the European Union and the International Monetary Fund (IMF) provided financial assistance to Ireland. The economic adjustment programme for Ireland included a joint financing package of EUR 85 billion for the period 2010-2013. In December 2013, Ireland successfully completed the EU-IMF financial assistance programme.

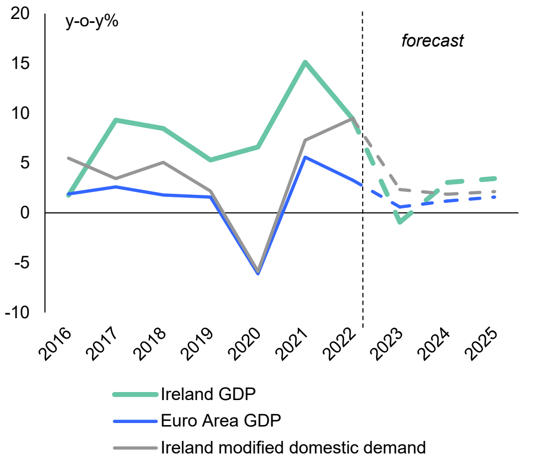
This report reflects information available and policy developments that have taken place up to 31 October 2023. The macroeconomic and budgetary projections, including those underlying the debt sustainability analysis, are in line with the Commission 2023 autumn forecast released on 15 November 2023 (with cut-off date 31 October 2023).

([3]) 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 on Ireland will last until 2031.

2. MACROECONOMIC DEVELOPMENTS

Economic growth is showing signs of moderation. In the first half of 2023 Ireland's real GDP grew by 0.1% year on year, held back by the performance of specific sectors dominated by multinationals, while modified domestic demand ([4]) increased by 1.9%. GDP growth is expected to decline in 2023 due to global headwinds faced by multinational corporations and a normalisation following the recent surge in growth rates (see Graph 2.1). The gradually improving external environment, a strong domestic economy and decelerating headline inflation suggest a positive outlook for Ireland in 2024 and 2025, although geopolitical risks and industry-specific risks contribute to considerable uncertainty.

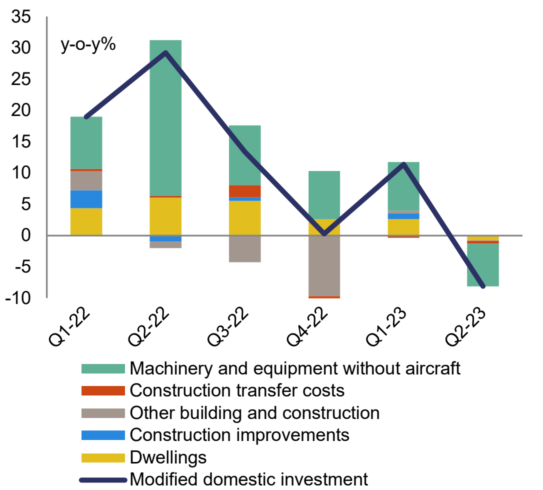
Graph 2.1: **Yearly GDP and modified domestic demand growth forecast**



Source: European Commission, CSO

Investment activity is projected to slow in 2023. In the first half of 2023 total investment declined, both in headline terms and on the 'modified' investment measure (which strips out aircraft leasing and intellectual property transactions). Modified investment has been volatile in recent quarters, reflecting the large-scale expansion in plant and machinery (see Graph 2.2). With such investment now moderating, the outlook for modified investment is starting to normalise again. In 2023 and 2024, tighter financial conditions and muted demand are expected to lead to subdued growth of modified investment compared to previous years. However, an improvement in financial conditions and the continuation of the national development plan point to a more positive investment outlook in 2025.

Graph 2.2: **Contributions to modified domestic investment**



(1) Expenditure on GNP
Source: CSO

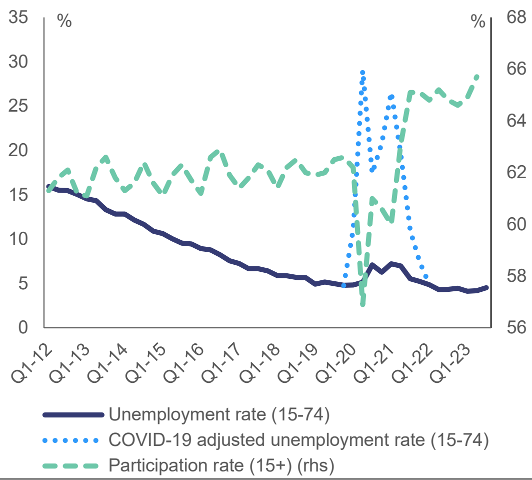
Private consumption proved resilient to the cost-of-living shock, but inflation will continue to weigh on household spending. In the first half of 2023, robust employment and government support measures supported household spending. However, tighter financial conditions are expected to weigh on the discretionary spending of households in the coming quarters. High frequency data indicate that consumer demand eased in the third quarter of this year, with consumer sentiment and retail sales weakening over the summer. Going forward, the combination of a strong labour market and growth in real disposable incomes are likely to continue to support consumption in the coming years.

The labour market is still tight, with employment at record highs. The unemployment rate in Ireland continued to remain low in 2023, averaging 4.3% in the first 9 months of the year (see Graph 2.3). Employment levels remained strong throughout the first half of 2023, with 2.6 million people in employment by the end of the second quarter, the highest number on record. The increase in employment was supported by an increase in the labour supply, driven by both an

([4]) Modified domestic demand excludes large transactions by foreign corporations which do not have a big impact on the domestic economy. This gives a better indication than GDP of how the Irish domestic economy is doing.

increase in female participation and inward migration. Inward migration has increased significantly in the past year, with non-Irish nationals contributing materially to the expanding labour force and mitigating some labour shortages. Ukrainian refugees also added to the labour force, though their participation rates tend to be lower due to the composition of arrivals (predominantly women with children).

Graph 2.3: **Unemployment and participation rates**

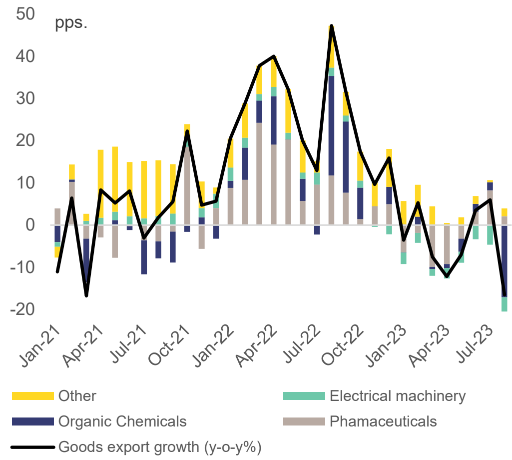


Six-month moving average
Source: CSO

Skills and labour shortages remain widespread. This affects all skill categories but there has been a moderate fall in job vacancies across most sectors, with marked decreases occurring in the professional, scientific, and technical activities sector, the financial and insurance activities sector and the information and communications technology (ICT) sector. While the vacancy rate is slowly declining, the unemployment rate is projected to remain low, averaging 4.2% in 2023. Employment is expected to keep increasing but at a more moderate pace in 2024 and 2025, in line with the normalisation of economic activity.

Net exports started to ease after very high growth rates in previous years. Previously buoyant chemical and pharmaceutical exports faltered, which account for around two thirds of goods exports (see Graph 2.4), and semi-conductors and contract manufacturing trade also weakened. Developments in the chemicals and pharmaceutical sector likely reflect a return to post-Covid normalisation rather than deeper structural shifts within the industry. Meanwhile the decline in exports of semi-conductors can likely be attributed to reduced external demand along with the impact of US trade policies. Contract manufacturing was also negatively impacted by the slowdown in global demand along with developments in these two key sectors. By contrast, the ICT sector, which accounts for more than half of Ireland's services exports, continued to record solid growth in the first half of the year. The export outlook for 2023 is projected to be negative, but turn positive for the coming years, bolstered by recent large-scale investments and a somewhat more positive global trade outlook in 2024 and 2025. However, Ireland has a high sectoral concentration of exports, which increases exposure to a downturn in global demand, industry- or firm-specific structural changes or an acceleration of geo-economic fragmentation.

Graph 2.4: **Drivers of export growth**

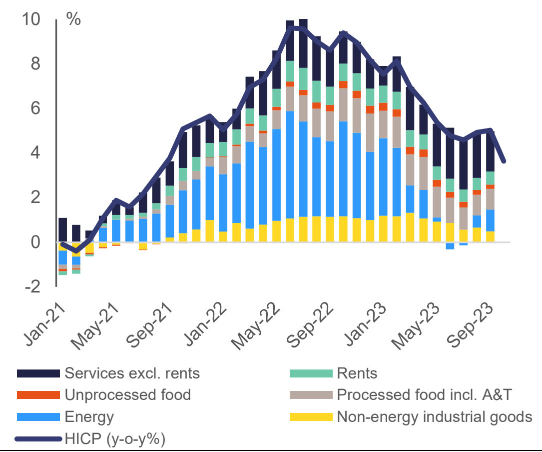


Source: CSO

Inflation based on the harmonised index of consumer prices (HICP) has peaked and is set to moderate. Easing of global energy prices, along with the normalisation of supply chains and tight monetary policy led to falling commodity prices and lower inflation in the first 8 months of 2023. Despite this, the transmission lag from wholesale to retail prices for gas and electricity has kept energy prices in Ireland comparatively high relative to the euro area average. Going forward, several domestic energy retailers have announced price decreases to come into effect in the coming months, leading to energy price easing. Food prices remained elevated in the first 8 months of 2023 but are expected to continue to decline due to considerable base effects, easing supply-side pressures, and an assumed decline in euro area food commodity prices. Going forward, domestic factors will increasingly influence inflation dynamics, with strong demand in an economy that is operating at capacity adding to price pressures. Services inflation has been persistent and is expected to remain higher for longer, in light of tight labour market conditions.

Price pressures are expected to continue moderating as monetary tightening continues to work its way through the economy. HICP inflation is projected to be 5.3% in 2023, 2.7% in 2024 and 2.1% in 2025. Upside risks remain, including the speed at which wholesale commodity prices are passed through to consumers, adverse weather effects impacting food prices, further increases in energy prices and escalations of geopolitical tensions leading to more fragmented supply chains. Additional risks relate to a chronic undersupply of housing.

Graph 2.5: **HICP inflation components**



Source: Eurostat

The pace of housing construction has held up in the face of high inflation. In the first half of 2023, new housing completions remained stable at around 30 000 units completed yearly. Increased government spending counterbalanced the strong increase in the cost of construction materials in 2022 and the first half of 2023. Looking ahead, while inflationary pressures have started to decrease, higher financing costs and capacity constraints in the construction sector are expected to weight on housing completions.

House price growth has continued cooling in the first half of 2023. In nominal terms, house prices have been relatively stable since autumn 2022, as rising mortgage interest rates have curbed demand. Yearly house price inflation declined to 0.9% in August 2023, with price increases remaining positive outside Dublin (3.1%) but negative in the capital (-1.9%). House price growth is expected to remain subdued in the short-term but accumulated supply shortages and strong population growth are expected to support prices over the medium term.

Rental prices continued to show strong growth in the first half of 2023 as the market remained very tight. Though public investment in cost-rental projects is underway, this is still being outpaced by the steady withdrawal of small-scale private landlords from the market. The limited supply was further strained by strong inward migration. In addition, most large institutional investors have temporarily paused new investment in large-scale rental projects due to the increase in financing costs. According to rental platform data, the number of properties available for rent remains below half of pre-pandemic levels ([5]). This lack of rental accommodation has become a key challenge and is hindering the recruitment of skilled labour from abroad.

The office rental market is facing a downturn and vacancy rates have increased, but spillover risks remain limited for domestic banks. The shift to hybrid working and the slowdown in the ICT sector has led to a decrease in office space needed, while a pre-pandemic investment boom caused excess supply. This poses significant risks, particularly in the non-prime office space. The vacancy rate for offices in Dublin increased from less than 10% in Q2 2022 to 13.6% in Q2 2023, but remains below the 20%+ rates seen during the global financial crisis ([6]). However, the potential negative impact on domestic banks appears contained given their relatively limited exposures (see Section 4).

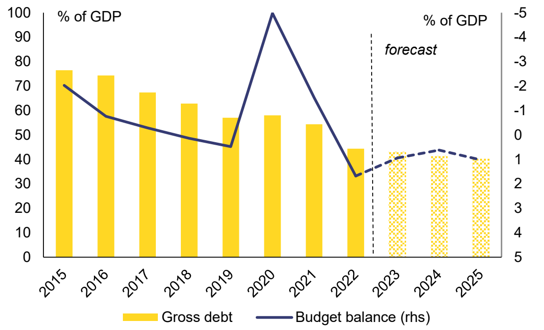
([5]) Daft.ie (2023) Q2 Rental Price Report.
([6]) Coldwell Banker Richard Ellis (2023) Dublin Office Market Q2 2023.

3. PUBLIC FINANCE DEVELOPMENTS

The outlook for public finances is favourable. On a general government basis, Ireland is expected to achieve a surplus in 2023, of 0.9% of GDP, according to the Commission 2023 autumn forecast. In the first half of 2023, the general government recorded a surplus of over EUR 4 billion; and, according to the Irish authorities (7), the surplus is expected to approach EUR 9 billion by the end of the year. General government revenue proved resilient in the first half of 2023 compared to the same period in 2022; however, the outlook is made to seem better by the high level of corporate tax receipts, half of which could be considered windfalls according to analysis done by the Irish authorities. Government expenditure increased by 5% in the first half of 2023, compared to the same period of 2022, amid delays in capital spending. According to the Commission's 2023 autumn forecast, Ireland's general government balance is projected to reach 0.6% of GDP in 2024, and 1.0% in 2025 (see Graph 3.2). On 10 October 2023, the Irish government unveiled a package of measures worth EUR 14 billion (2.5% of GDP) as part of their annual budget for 2024. These fiscal measures include tax cuts; increases to welfare and pension payments; mortgage interest rate tax relief; additional payments of energy credits; and an extension of the reduced 9% rate of VAT for the supply of gas and electricity to the end of October 2024. The Commission forecast incorporates these fiscal measures and is broadly in line with surpluses projected by the Irish authorities of 1.6% of GDP in 2023; 1.5% in 2024 and 2.3% in 2025.

Government debt is expected to decline steadily relative to economic activity in the next few years. As of the first half of 2023, the debt ratio was 43% of GDP and almost 80% of GNI* (8). While budget surpluses are expected throughout the forecast horizon, the debt level is forecast to decrease only marginally because of planned financial transactions in assets (9) that are not contributing to the general government balance. Ireland's gross general government debt-to-GDP ratio is expected to decrease to 43.0% in 2023; 41.4% in 2024 and 40.2% in 2025, in the Commission 2023 autumn forecast. As a measure of the debt burden relative to the domestic economy, the Irish authorities project a debt-to-GNI* ratio of 76.1% in 2023 and 72.3% in 2024 and 68.4% in 2025.

Graph 3.1: **General government budget balance and gross debt forecast**



Source: European Commission

To address fiscal-structural challenges that impinge on long-term fiscal sustainability, Ireland plans to establish a 'Future Ireland Fund' in 2024. The aim of this strategy is to 'pre-fund' costs related to issues including population ageing, and the digital and climate transitions, to the extent possible. As pointed out in previous PPS reports, population ageing will weigh on the pension system's sustainability in the absence of structural reforms. However, Ireland has announced it will start raising pay-related social insurance rates to fund part of the pension costs increases. It will do so incrementally over a number of years, starting with a 0.1 pps increase from 1 October 2024. It is planned that the 'Future Ireland Fund' will be funded by contributions from the Exchequer of 0.8% of GDP annually from 2024 to 2035, and around EUR 4 billion in seed funding from the National Reserve Fund, which is proposed to be dissolved. Ireland also plans to establish an Infrastructure, Climate and Nature

(7) Budget 2024: Economic and fiscal outlook, gov.ie

(8) 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 redomiciled to Ireland.

(9) These financial assets include liquid assets held by the Irish Exchequer, Ireland Strategic Investment Fund cash and non-equity investments and other cash and liquid assets held by the general government sector.

Fund in 2024. In 2024, EUR 2 billion will be transferred to this fund from the proceeds of the proposed dissolution of the National Reserve Fund. It is intended that the fund will be used for expenditure in times of significant deterioration in public finances, and for individual projects that contribute to the achievement of climate and nature-related goals.

Long-term fiscal-structural issues persist, such as the need to broaden the tax base. About one in three income earners is exempt from taxes as their standard rate liability is covered by credits or age-exemption limits. Despite Ireland having a (non-binding) expenditure rule, in 2024 it plans to deviate from it for the second year in a row, albeit marginally. The Irish fiscal council and central bank have pointed to potential risks about the credibility of the rule, especially as the latest budget includes planned ‘windfall capital investment’, which is not included in the spending aggregate. However, international tax policy changes, such as implementation of the OECD’s Base erosion and profit shifting Pillar II, might not have an impact until 2025 or 2026. According to a debt sustainability analysis, Ireland’s fiscal sustainability challenges appear low over the short and medium term, and medium over the long term (see Annex 2).

4. FINANCIAL SECTOR DEVELOPMENTS

Domestic retail banks maintain capital buffers above regulatory requirements. The three remaining retail banks ([10]) reported a decline in their transitional Common Equity Tier 1 (CET1) capital ratio to 15.6% in June 2023, from 17.0% at end 2022. This decline was driven primarily by an increase in their risk-weighted assets, as they took on loan portfolios from the two banks withdrawing from the Irish market.

Retail banks continue to have ample stocks of liquid assets, even after using some of their excess liquidity to fund the acquisition of assets from the two exiting banks. The retail banks' liquidity coverage ratio and net stable funding ratio declined in 2022 and the first half of 2023, to 177% and 156% respectively, but remain well above the regulatory minimum requirement of 100%. Irish retail banks' liquidity is supported by the steady availability of deposits, which have remained ample, despite the limited pass-through of central bank rate hikes to deposit rates. However, the growth of deposits slowed in the first half of 2023. Despite their observed stickiness, banks may have to raise deposit rates going forward, as borrowers might seek out higher-yielding investment products, possibly affecting banks' liquidity cushion.

Banks' profitability has been supported by rising net interest income. Irish retail banks reported strong results in the first half of 2023, with net profits increasing to EUR 1.7 billion compared with EUR 0.7 billion in the first half of 2022. Annualised return on equity reached 11.4% in the first quarter of 2023, up from 7.0% in 2022. Meanwhile annualised return on assets was 1.1%, compared to 0.7% in 2022. Net interest income was boosted by expanding loan volumes (partly driven by consolidation in the sector) and widening interest margins, as banks hiked their lending rates, while the pass-through of interest rate rises to deposits was limited. The increase in the remuneration of excess liquidity held at the ECB also contributed. Net fee and commission income also grew, outstripping the lower increase in operating costs, due mostly to rising staff expenses. Despite these positive developments, uncertainty remains over the sustainability of this level of profitability, given the potential pressure for higher deposit rates and the potential for adverse credit outcomes.

Non-performing loans (NPLs) continued to decline in the household sector but remain above pre-pandemic lows in the non-financial corporations (NFC) segment. Aggregate NPLs of Irish retail banks declined from a pandemic peak of EUR 10.0 billion in December 2020 to EUR 5.8 billion in June 2023. The three retail banks saw an uptick in their NPL stock in the first half of 2023, caused in part by the acquisition of non-performing assets from the exiting banks, but their NPL ratio was unchanged from December at 2.3% in June 2023 given a larger overall loan amount. Residential mortgage NPLs stood at EUR 2.2 billion in June corresponding to a ratio of 2.3%, down from the pandemic peak of 6.0% in the fourth quarter of 2020. While banks recorded improvements in the quality of their exposure to the household sector before and throughout the pandemic, the pandemic led to a deterioration in asset quality in the NFC segment. NPLs in the NFC segment jumped from their pre-pandemic minimum of EUR 2.2 billion to EUR 4.0 billion in December 2020. Since then, the NPL ratio of non-financial corporations has stayed above its pre-pandemic low and since December 2021 above the NPL ratio of households. In June 2023 it was 5.1%, or EUR 2.8 billion. NPL reductions in the past were mainly driven by portfolio sales, restructuring and securitisations but this activity has become more muted recently, as banks have approached their targeted NPL levels. So far, 2023 has seen one portfolio sale, worth EUR 0.7 billion.

The current number of business insolvencies remains benign despite cyclical headwinds. Insolvencies picked up from a low base to a total of 321 in the first half of 2023, compared to 208 in the same period of 2022, but they remained below the levels seen before the pandemic. However, banks have classified more of their business loans in the stage 2 category of increased risk, with the share of these loans rising to 27.2% in June 2023 from 24.1% in December 2022.

([10]) Two retail banks, KBC Ireland and Ulster Bank Ireland are in the process of withdrawing from the Irish market. Their assets have been acquired by the remaining three, domestically owned, retail banks: Bank of Ireland, AIB and Permanent TSB.

Table 4.1: **Financial soundness indicators**

	Ireland												Euro area	EU
in %	Q4-2015	Q4-2016	Q4-2017	Q4-2018	Q4-2019	Q4-2020	Q4-2021	Q1-2022	Q2-2022	Q3-2022	Q4-2022	Q1-2023	Q1-2023	Q1-2023
Non-performing loans	18.5	15.7	12.1	7.3	4.3	5.1	3.5	3.2	2.9	2.4	2.3	2.2	1.8	1.8
o/w NFC sector	29.0	21.4	15.3	8.1	4.0	7.6	7.7	6.5	6.6	6.0	5.5	5.1	3.3	3.2
o/w HH sector	15.4	14.4	12.8	8.1	5.5	6.1	4.3	4.3	3.8	3.1	2.4	2.4	2.1	2.1
Coverage ratio	38.8	35.6	30.3	28.8	27.9	31.4	31.7	32.7	32.0	31.3	32.8	32.8	45.2	44.9
Return on equity(1)	8.1	7.6	7.3	6.8	3.2	-6.3	6.3	5.1	5.3	6.3	7.0	11.4	9.7	10.1
Return on assets(1)	0.8	0.8	0.8	0.8	0.4	-0.6	0.6	0.5	0.5	0.5	0.7	1.1	0.7	0.7
Total capital ratio	18.1	20.1	21.1	20.2	20.8	21.6	23.2	22.5	21.2	20.5	21.9	19.9	19.3	19.4
CET 1 ratio	14.4	16.8	18.3	17.8	17.7	17.1	18.1	17.3	16.3	16.1	16.9	15.1	15.8	16.0
Tier 1 ratio	15.6	17.9	19.1	18.5	18.9	19.2	20.1	19.4	18.3	18.0	19.1	17.2	17.0	17.1
Loan to deposit ratio	95.6	94.7	94.4	92.8	91.0	83.9	72.7	75.5	72.6	72.8	74.6	79.7	88.8	91.5

(1) For comparability reasons, annualised values are presented.
The figures in the table refer to all domestic banking groups and stand-alone banks in Ireland. These figures may differ from those reported in the text, which generally refer exclusively to the three main domestic retail banks.
Source: ECB - Consolidated banking data; own calculations.

The hospitality and the real estate sectors remain the most exposed to deteriorating credit risk. The sectors with the highest NPL shares are the hospitality sector, with an NPL ratio of 11.6% in June 2023 corresponding to a stock of EUR 456 million, and the real estate sector with an NPL ratio of 4.9% and a stock of EUR 752 million. These sectors are also the ones with the largest stocks of loans classified as stage 2, which account for 47% of all loans to the hospitality sector, corresponding to EUR 1.8 billion, and 43% of loans for real estate activities, resulting in a stock of EUR 6.6 billion.

In the real estate sector, the downturn in the commercial real estate market, especially the office market, has translated into increased risks for the corporate loan book. As described in Section 2 and observed in other countries, the commercial real estate sector, particularly the office market, has come into focus due to both structural and cyclical vulnerabilities. Commercial real estate (CRE) prices fell by 12.2% on average in the 12 months to June 2023, with the drop most pronounced in the office segment (-14.7%). Further price drops of similar magnitude this year and next seem likely. Some property funds are exposed to refinancing risk, as the costs of new loans have risen. Retail banks have CRE loans ([11]) worth EUR 16.9 billion on their books, corresponding to 31% of their NFC loans or 86% of their regulatory tier 1 capital. Their exposure is thus not particularly large compared with other EU countries. Given the negative outlook in the CRE market banks are holding 43% of their CRE exposures in stage 2 as of 30 June 2023, up from 34% six months earlier.

Retail banks increased their impairment charges this year, driven by a general deterioration in the economic outlook. The retail banks registered impairment charges ([12]) of EUR 288 million in the first half of 2023. Provisioning levels for NPLs, at 31.6%, are lower than the EU average of 43.6%. The central bank points out that a large proportion of the NPLs are collateralised and therefore may require lower provisioning levels. Further, Irish retail banks are subject to calendar provisioning, which means deductions are made directly off regulatory capital, and these are not reflected in reported provisioning ratios.

New domestic lending activities were driven by mortgages and consumer credit, while NFC lending slowed. New domestic mortgage lending picked up in the first half of 2023, reversing the negative trend ongoing since 2022, with outstanding amounts increasing by EUR 1 billion between February and August 2023, to EUR 83.6 billion. The revised mortgage measures in place since the beginning of 2023 ([13]) likely supported new mortgage lending activity. In line with the trend observed in recent years, new mortgage lending by Irish banks is almost entirely based on fixed-rate contracts, with fixation periods

([11]) The EBA classifies loans as CRE loans if they are collateralised by CRE or if their purpose is to finance CRE.

([12]) Impairment charges refer to the permanent reduction in asset values recorded by banks over a given period. Here, provisions refer to accumulated impairment charges.

([13]) The mortgage measure revision included, among others, changes to the loan-to-income ratio ceiling for first-time buyers (up from 3.5x to 4x), and to the loan-to-value ceiling for secondary or subsequent buyers (up from 80% to 90%).

typically of 3-5 years. This reduces uncertainty about borrowers' repayment capacity over the medium term. Consumer credit to Irish households increased markedly over the first 8 months of 2023, but remains a limited share of banks' loan portfolios, worth EUR 12.1 billion in August 2023.

Loan origination to domestic non-financial corporates remains weak, reflecting businesses' ample liquidity levels and uncertainty in the economic outlook. Outstanding loans to NFCs declined from EUR 31.7 to EUR 30.8 billion in the eight months of 2023. A similar development was recorded for Small and medium-sized enterprises (SMEs), for which outstanding loans declined from EUR 18.2 billion to EUR 17.9 billion between end 2022 and June 2023, in line with the downward trend of recent years. In the first half of 2023, new lending to the sector was EUR 1.8 billion, down 14% from the first half of 2022. Irish investment banks hold large stocks of NFC loans but remain mainly focused on serving corporates and financial institutions in other EU Member States.

The Central Bank of Ireland (CBI) raised the countercyclical capital buffer (CCyB) rate, from 1.0% to 1.5% in June 2023. The increase will be effective from June 2024. This level is deemed appropriate for a standard risk environment, i.e., when risks are neither elevated nor subdued. Given the capital headroom in the domestic banking sector and its positive profitability outlook, the increase in the CCyB is not expected to have a material effect on credit supply or on the real economy. Previously, the buffer was increased from 0% to 0.5% in June 2022, and to 1% in November 2022. The CBI also requires additional buffers between 0.5% and 1.5% to six banks that are currently considered as other-systemically important institutions (O-SII). This is to address the material impact that failure or distress of these large, complex and heavily interconnected banks may have on the rest of the financial system and the broader economy. The CBI also keeps a series of mortgage measures in place. The last adjustments to this framework came into effect in January 2023. The central bank is currently not considering the introduction of a systemic risk buffer for risks in the CRE market.

The Irish market-based financial sector (MBF) increased in size over the first half of 2023, reporting total assets of EUR 5.4 trillion as at June 2023. Its growth was mainly driven by revaluations in equity markets, which in the first half of 2023 pushed up the asset value of equity funds by EUR 165 billion, to EUR 1 465 billion. Net inflows were limited but positive. Over the same period, bond funds increased their assets under management, driven by increasing valuations and also benefiting from net inflows of EUR 37 billion in the second quarter of 2023. The size of the MBF sector remains below its level at end-2021 (over EUR 5.6 trillion), and is expected to decline further, following the recent increase in yields which are not factored in yet in the publicly available data. The MBF sector keeps displaying only limited interlinkages with the domestic economy, mostly related to property funds and securitisation on banks' loans. However, the very large size of the sector and the possible systemic implications warrant close monitoring.

Higher funding costs and the negative outlook in the CRE market have had a negative impact on non-bank lenders and property funds. Non-bank lenders (NBLs) play an important role in financing Irish NFCs and especially SMEs. NBLs' reliance on wholesale funding, however, means they are more exposed than banks to interest rate hikes. As interest rates kept rising in 2022 and 2023, tighter financing conditions led to a reduction in new lending. Going forward, it will be important to ensure continued access to financing for businesses in the sectors that most rely on NBLs, such as real estate, construction, and transport. Among non-bank financial institutions, property funds remain the most exposed to the Irish domestic economy, holding approximately 35% of the Irish investable CRE market. However, the macroprudential measures for property funds introduced in November 2022 by the CBI (i.e. a leverage limit of 60% and a guidance around imposing a liquidity timeframe of at least 12 months for Irish property funds covered by the measure) are expected to mitigate the risks stemming from this sector. For existing funds, these measures will be phased in (over 5 years for the leverage limits and 18 months for the liquidity guidelines) to facilitate a gradual and orderly adjustment to the measures and in view of the current macroeconomic environment. However, the strong price corrections ongoing in certain CRE market segments, leave significant short- and medium-term risks.

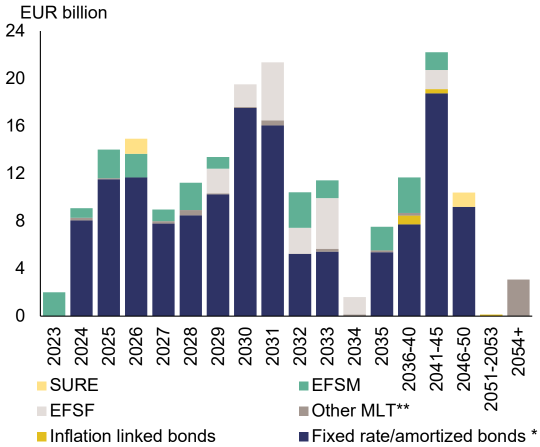
5. SOVEREIGN FINANCING AND CAPACITY TO REPAY

Ireland's fiscal sustainability challenges appear low over the short and medium term, and medium over the long term. Under an alternative scenario in the debt sustainability analysis, where interest rates temporarily increase by 1 percentage point compared with the baseline, government debt ratio would be broadly unchanged compared with the baseline in 2034. However, debt would be higher than under the baseline by about 19 percentage point of GDP in 2034, under a scenario where the structural primary balance returns to its historical 15-year average of -1.8% of GDP. Nonetheless, the debt ratio would still be below 60% of GDP (see Annex 2).

Ireland is set to deal with higher sovereign borrowing costs from a solid position. In December 2021, the ECB started on a path of monetary policy normalisation. Since then, it has raised its main policy rates by 4.5 percentage points, ended its net purchases under the pandemic emergency purchase programme, and started unwinding the portfolio acquired under the asset purchase programme by no longer reinvesting the principal payments from maturing securities. Yields for the 10-year Irish government bond were around 3.2% at the end of October 2023, a mild increase from about 3% at the start of 2023. Spreads against the German benchmark were stable at around 40 basis points. Moreover, by September 2023, Ireland held a large liquid asset balance of EUR 28 billion. By the end of 2023, these balances are expected to be slightly above the EUR 23 billion level recorded at the beginning of the year.

Irish sovereign debt continues to be perceived positively by the market. All major rating agencies rate Ireland in the AA-equivalent category. By the end of September 2023, Ireland had completed bond issues for the year, having issued government bonds to the value of EUR 7 billion of, the lower end of the EUR 7-11 billion funding range for 2023. The funding strategy is based on maintaining market access and liquidity. Interest expenditure on government debt is projected to remain at 1.1% of GNI* every year between 2023 and 2026, according to the Irish authorities' latest projections. The impact risk from an increase in borrowing costs is 'medium' ([14]) for Irish sovereign debt. However, Ireland's refinancing needs are low.

Graph 5.1: **Maturity profile of medium- and long-term debt (end-September 2023)**



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.
** Excludes other medium and long-term loans (MLT) of EUR 5 million.
Source: NTMA

Ireland is servicing its debt to official creditors. Ireland owes an outstanding debt of EUR 22.5 billion to the European Financial Stability Mechanism (EFSM) and EUR 18.4 billion to the European Financial Stability Facility (EFSF). Ireland's first EFSF payment is scheduled in 2029 and the first EFSM maturity – of EUR 2 billion – was met in the fourth quarter of 2023.

Ireland retains the capacity to service its debt. As of the first quarter of 2023, official loans, Eurosystem bond holdings and domestic retail holdings – known as 'sticky' sources – accounted for about 60% of Irish government debt, similar to the rates in 2021 and 2022. The investor base remains wide and varied, with a fifty-fifty split between non-resident and resident holdings of debt and a dominant share of non-domestic investors over the most recent syndications.

([14]) On a scale of 'low/medium/high' risk, Budget 2024: Economic and fiscal outlook, gov.ie

ANNEX 1
Main macroeconomic indicators

Table A1.1: **Selected economic indicators**

	2019	2020	2021	2022	2023	2024	2025
Real economy			*(percent change)*				
Real GDP	5.3	6.6	15.1	9.4	-0.9	3.0	3.4
Domestic demand incl. inventories	42.6	-10.7	-16.7	8.3	0.6	2.2	2.5
Private consumption expenditure	2.5	-10.8	8.5	9.4	3.2	3.0	2.9
Government consumption expenditure	6.2	10.3	6.6	4.5	1.7	0.6	0.8
Gross fixed capital formation	100.7	-16.5	-40.4	5.1	-2.9	2.5	3.2
Exports of goods and services	11.8	11.5	15.1	13.9	-1.5	3.5	4.1
Imports of goods and services	42.3	-1.7	-7.5	15.9	-0.8	3.1	3.8
Contribution to growth			*(percentage points)*				
Domestic demand (excl. inventories)	30.1	-10.9	-14.0	4.0	0.4	1.4	1.5
Foreign trade	-25.3	16.9	28.6	3.7	-1.3	1.7	1.9
Changes in inventories	0.3	0.6	0.5	1.0	0.0	0.0	0.0
Inflation			*(percent change)*				
GDP deflator	3.4	-1.2	0.5	6.6	5.1	2.6	1.9
HICP	0.9	-0.5	2.4	8.1	5.3	2.7	2.1
Labour market			*(percent change, unless otherwise stated)*				
Unemployment rate (% of labour force)	5.0	5.9	6.2	4.5	4.2	4.2	4.3
Employment	3.0	-2.8	6.0	6.6	3.4	1.4	1.3
Compensation per employee	3.8	3.7	2.6	2.7	5.0	5.5	5.2
Labour productivity	2.3	9.7	8.6	2.6	-4.2	1.6	2.1
Unit labour costs	1.5	-5.5	-5.5	0.1	9.6	3.8	3.0
Public finance			*(percent of GDP)*				
General government balance	0.5	-5.0	-1.5	1.7	0.9	0.6	1.0
Total revenue	24.8	22.2	22.9	22.9	23.0	22.5	22.4
Total expenditure	24.3	27.2	24.4	21.2	22.1	21.9	21.4
General government primary balance	1.8	-4.0	-0.8	2.3	1.6	1.3	1.7
Gross debt	57.1	58.1	54.4	44.4	43.0	41.4	40.2
Balance of payments			*(percent of GDP)*				
Current external balance	-19.8	-6.8	14.0	10.8	9.9	10.6	11.4
Ext. bal. of goods and services	3.5	18.8	40.1	39.9	39.0	39.3	39.6
Exports goods and services	128.0	132.9	133.7	137.1	132.6	131.8	131.6
Imports goods and services	124.5	114.1	93.7	97.2	93.6	92.5	92.0

Source: European Commission

ANNEX 2
Debt sustainability analysis

This annex assesses fiscal sustainability risks for Ireland over the short, medium and long term. It follows the same multi-dimensional approach as the European Commission's 2022 Debt Sustainability Monitor, updated based on the Commission 2023 autumn forecast and including a technical change to anchor the fiscal variables to the structural primary balance of the first forecast year (t+1) as opposed to the second forecast year (t+2) in previous publications. This change aims to ensure a higher degree of stability and consistency with the ongoing work on the revision of the economic governance framework. This means that the debt and budget balance projections for t+2 (in this case 2025) can differ from the Commission 2023 autumn forecast. A more detailed description and explanation of this update will be published in the forthcoming Debt Sustainability Monitor 2023.

SHORT-TERM RISKS

Short-term risks to fiscal sustainability are low. The Commission's early-detection indicator (S0) does not point to any major short-term fiscal risks (Table A2.3). ([15]). Government gross financing needs are expected to remain low in the short term at around 3% of GDP on average over 2023-24 (Table A2.1). Irish sovereign debt continues to be perceived positively by the market. All major rating agencies rate Ireland in the AA-equivalent category.

MEDIUM-TERM RISKS

Medium-term fiscal sustainability risks appear low. The DSA baseline shows that the government debt-to-GDP ratio is projected to continue declining over the medium term, to around 34% of GDP in 2034. (Graph A2.1, Table A2.1) ([16]). The debt reduction is supported by the assumed structural primary surplus of 0.8% of GDP. This appears plausible compared with past fiscal performance ([17]). The debt decline also benefits from a still favourable but decreasing snowball effect of around 1.1% of GDP annually on average over 2025-2034. Government gross financing needs are expected to remain low over the projection period at around 3.5% of GDP on average.

The baseline projections are stress-tested against four alternative deterministic scenarios to assess the impact of changes in key assumptions relative to the baseline (Graph A2.1). Under the *historical structural primary balance (SPB) scenario* (i.e. the SPB returns to its historical 15-year average of -1.8% of GDP) the debt ratio would be higher than under the baseline by about 19 pps. of GDP in 2034, though still below 60% of GDP. Under the *adverse interest-growth rate differential scenario* (i.e. the *interest-growth rate* deteriorates by 1 pp. of GDP compared with the baseline), the debt ratio would be somewhat higher than under the baseline by around 3 pps. in 2034. Under the *financial stress scenario* (i.e. interest rates temporarily increase by 1 pp. compared with the baseline) the government debt ratio would be broadly unchanged compared with the baseline in 2034. Finally, under the *lower structural primary balance scenario* (i.e. the projected cumulative improvement in the SPB over 2023-2024 is halved) the debt ratio would be slightly higher than under the baseline by 1.4 pps. in 2034.

The stochastic projections indicate low risk, pointing to a limited sensitivity of these projections to plausible unforeseen events ([18]).

([15]) The S0 is a composite indicator of short-term risk of fiscal stress. It is based on a wide range of fiscal and financial-competitiveness indicators that have proven to be a good predictor of emerging fiscal stress in the past.

([16]) The assumptions underlying the Commission's 'no-fiscal policy change' baseline include in particular: (i) a structural primary surplus, before ageing costs, of 0.8% of GDP from 2024 onwards; (ii) inflation converging linearly towards the 10-year forward inflation-linked swap rate 10 years ahead (which refers to the 10-year inflation expectations 10 years ahead); (iii) the nominal short- and long-term interest rates on new and rolled over debt converging linearly from current values to market-based forward nominal rates by T+10; (iv) real GDP growth rates from the Commission 2023 autumn forecast until 2025, followed by the EPC/OGWG 'T+10 methodology projections between T+3 and T+10 (average of 2.9%); (v) ageing costs in line with the 2021 Ageing Report (European Commission, Institutional Paper 142, November 2020). For information on the methodology, see the 2022 Debt Sustainability Monitor.

([17]) This assessment is based on the consolidation space indicator, which measures the frequency with which a tighter fiscal position than assumed in a given scenario has been observed in the past. Technically, this consists of looking at the percentile rank of the projected SPB within the distribution of SPBs observed in the past in the country, taking into account all available data from 1980 to 2022.

([18]) The stochastic projections show the joint impact on debt of 2000 different shocks affecting the government's

Table A2.1: **Baseline debt projections**

	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032	2033	2034
Gross debt ratio (% of GDP)	**54.4**	**44.4**	**43.0**	**41.4**	**41.0**	**38.9**	**37.1**	**35.8**	**34.7**	**33.9**	**33.4**	**33.2**	**33.3**	**33.6**
Changes in the ratio	-3.7	-10.0	-1.4	-1.6	-0.4	-2.1	-1.7	-1.3	-1.1	-0.8	-0.5	-0.2	0.1	0.3
of which														
Primary deficit	0.8	-2.3	-1.6	-1.3	-0.9	-0.6	-0.4	-0.1	0.1	0.3	0.4	0.6	0.7	0.9
Snowball effect	-7.1	-7.1	-1.1	-1.7	-1.5	-1.5	-1.3	-1.3	-1.2	-1.1	-0.9	-0.8	-0.6	-0.6
Stock-flow adjustments	2.7	-0.6	1.3	1.4	2.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gross financing needs (% of GDP)	5.7	2.5	2.7	2.9	4.1	2.6	2.5	3.0	3.3	3.3	3.9	4.2	4.5	4.1

Source: European Commission

These stochastic simulations indicate a 29% probability that the debt ratio will be higher in 2028 than in 2023, implying low risks given the low debt level. Though, the uncertainty surrounding the baseline debt projections is medium, as 80% of the simulated debt paths lie in a wide range of 31 pps. in five years time (Graph A2.2).

LONG-TERM RISKS

Long-term fiscal sustainability risks appear overall medium. This assessment is based on the combination of two fiscal gap indicators, capturing the required fiscal effort to stabilise debt (S2 indicator) and bring to 60% of GDP (S1 indicator) over the long-term ([19]). This assessment is mainly driven by the projected increasing ageing costs.

The S2 indicator points to medium fiscal sustainability risks. The indicator shows that, relative to the baseline, the SPB would need to improve by 4.3 pps. of GDP to ensure debt stabilisation over the long term. This result is driven by the projected increase in ageing-related costs (contribution of 4.9 pps. of GDP), which is only partly offset by the favourable initial budgetary position (-0.6 pp. pps. of GDP). In particular the projected increase in pension expenditure (contribution of 2.3 pps. of GDP), but also of healthcare and long-term care spending (+1.2 pps. and +1.6 pps. of GDP respectively) drive these results (Table A2.2).

The S1 indicator points to low fiscal sustainability risks. The indicator shows that the country needs to improve its fiscal position by 1.9 pps. of GDP to keep its debt below 60% of GDP by 2070. This result is mainly driven by the projected increase in age-related public spending (contribution of 3.5 pps. of GDP) that is only partially offset by the current favourable initial budgetary position (contribution of -1.1 pps. of GDP) and the current distance of the government debt ratio from the 60% reference value (contribution of-0.4 pps. of GDP) (Table A2.2).

Finally, several additional risk factors need to be considered in the assessment. On the one hand, interest rates hikes, a share of short term debt higher than most EU member states and the share of public debt held by non residents are risk-increasing factors. Moreover, the government debt ratio remains above 60% when replacing GDP with modified gross national income (GNI*), a measure that reflect the income standards of Irish residents more accurately. While the large negative net international investment position is a potential concern, it must be viewed in the context of significant activity of multinationals in Ireland, and Ireland's status as an international financial services hub.

On the other hand, risks are mitigated by the stability of financing sources – supported by a large and diversified investor base – the absence of currency mismatch, and borrowing costs that are still low in historical perspective. Moreover, the weighted average maturity of the medium/long term debt portfolio was only slightly more than 10 years at end of the third quarter of 2023. Finally, a

budgetary position, economic growth, interest rates and exchange rates. This covers 80% of all the simulated debt paths and therefore excludes tail events.

([19]) The S2 fiscal sustainability indicator measures the permanent SPB adjustment in 2024 that would be required to stabilise public debt in the long term. It is complemented by the S1 indicator, which measures the permanent SPB adjustment in 2024 to bring the debt ratio to 60% by 2070. For both the S1 and S2 indicators, the risk assessment depends on the amount of fiscal consolidation needed: 'high risk' if the required effort exceeds 6 % of GDP, 'medium risk' if it is between 2% and 6% of GDP, and 'low risk' if the effort is negative or below 2% of GDP. The overall long-term risk classification combines the risk categories derived from S1 and S2. S1 may notch up the risk category derived from S2 if it signals a higher risk than S2. See the 2022 Debt Sustainability Monitor for further details.

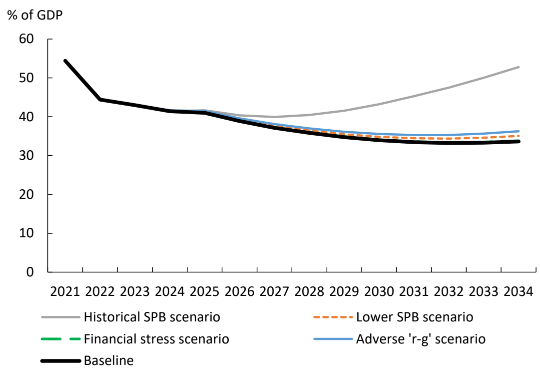
Table A2.2: **Breakdown of the S1 and S2 sustainability gap indicators**

		S1	S2
Overall index (pps. of GDP)		**1.9**	**4.3**
of which			
Initial budgetary position		-1.1	-0.6
Debt requirement		-0.4	
Ageing costs		3.5	4.9
of which	*Pensions*	1.9	2.3
	Health care	0.8	1.2
	Long-term care	0.9	1.6
	Others	-0.1	-0.1

Source: European Commission

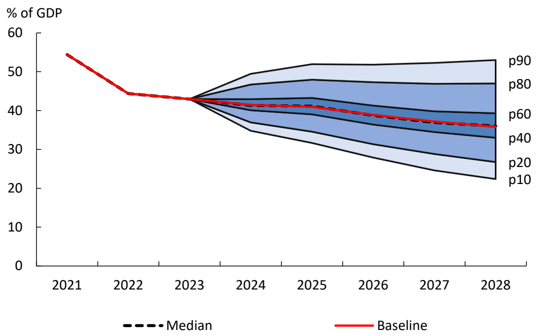
full implementation of the structural reforms under the Irish Recovery and Resilience Plan could have a further positive impact on GDP growth in the coming years, and therefore help to mitigate debt sustainability risks.

Graph A2.1: **Deterministic debt projections**



Source: European Commission

Graph A2.2: **Stochastic debt projections 2024-2028**



Source: European Commission

Table A2.3: **Heat map of fiscal sustainability risks**

Short term	Medium term - Debt sustainability analysis (DSA)								Long term		
Overall (S0)	Overall		Deterministic scenarios: Baseline	Historical SPB	Lower SPB	Adverse 'r-g'	Financial stress	Stochastic projections	S2	S1	Overall (S1 + S2)
LOW	LOW	Overall	LOW	LOW	LOW	LOW	LOW	LOW	MEDIUM	LOW	MEDIUM
		Debt level (2034), % GDP	33.6	52.8	35.0	36.2	33.8				
		Debt peak year	2023	2034	2023	2023	2023				
		Fiscal consolidation space	58%	74%	60%	58%	58%				
		Probability of debt ratio exceeding in 2028 its 2023 level						29%			
		Difference between 90th and 10th percentiles (pps. GDP)						30.6			

(1) Debt level in 2034. Green: below 60% of GDP. Yellow: between 60% and 90%. Red: above 90%. (2) The debt peak year indicates whether debt is projected to increase overall over the next decade. Green: debt peaks early. Yellow: peak towards the middle of the projection period. Red: late peak. (3) Fiscal consolidtation space measures the share of past fiscal positions in the country that were more stringent than the one assumed in the baseline. Green: high value, i.e. the assumed fiscal position is plausible by historical standards and leaves room for corrective measures if needed. Yellow: intermediate. Red: low. (4) Probability of debt ratio exceeding in 2028 its 2023 level. Green: low probability. Yellow: intermediate. Red: high (also reflecting the initial debt level). (5) the difference between the 90th and 10th percentiles measures uncertainty, based on the debt distribution under 2000 different shocks. Green, yellow and red cells indicate increasing uncertainty.
Source: European Commission (for further details on the Commission's multidimensional approach, see the 2022 Debt Sustainability Monitor)

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