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Post-Programme Surveillance Report

Ireland, Autumn 2017

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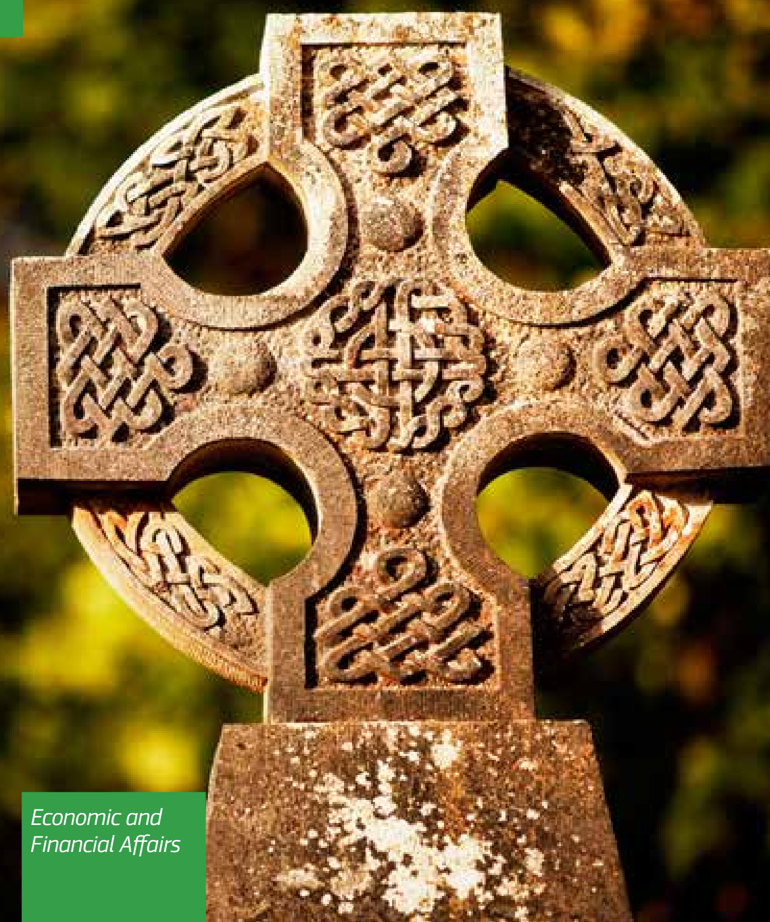
EUROPEAN ECONOMY



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European Commission
Directorate-General for Economic and Financial Affairs

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Institutional Paper 074

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This report reflects information available up until 20 December 2017

ABBREVIATIONS

AIB	Allied Irish Bank
BEPS	Base Erosion and Profit Shifting
BOI	Bank of Ireland
CBI	Central Bank of Ireland
CSO	Central Statistics Office Ireland
CSR	Country specific recommendation
CRE	Commercial real estate
ECB	European Central Bank
EBA	European Banking Authority
EDP	Excessive deficit procedure
EFC	Economic and Financial Committee
EFSF	European Financial Stability Facility
EFSM	European Financial Stabilisation Mechanism
ESM	European Stability Mechanism
FTB	First-time buyer
GVA	Gross Value Added
HICP	Harmonised Index of Consumer Prices
IDR	In-depth review
IMF	International Monetary Fund
MIP	Macroeconomic imbalance procedure
MNE	Multinational enterprise
NAMA	National Asset Management Agency
NPLs	Non-performing loans
NTMA	National Treasury Management Agency
PMI	Production managers index
PPS	Post-programme surveillance
PTSB	Permanent TSB
SGP	Stability and Growth Pact
SME	Small and medium sized enterprises
SPV	Special purpose vehicle
SSM	Single Supervisory Mechanism
USC	Universal Social Charge
VAT	Value added tax
y-o-y	Year-on-year

EXECUTIVE SUMMARY

Staff from the European Commission, in liaison with staff from the European Central Bank, visited Dublin from 28 November to 1 December 2017 to conduct the eighth post-programme surveillance (PPS) review mission for Ireland. Staff from the European Stability Mechanism also participated in the meetings on aspects related to its Early Warning System. The mission was coordinated with an International Monetary Fund Staff Visit. The main objective of PPS is to assess the country's capacity to repay the loans granted under the former EU-IMF financial assistance programme and, if necessary, to recommend corrective actions.

The strong momentum in the Irish economy is expected to continue in the short term, but risks remain tilted to the downside. While the headline figures remain volatile and heavily influenced by the activities of multinational enterprises, underlying domestic activity is growing at a solid pace, buoyed by robust employment growth, private consumption and strong investment in construction. Risks to the economic outlook relate primarily to the outcome of the negotiations regarding the UK's exit from the European Union and potential changes to the international taxation environment. Risks could also arise in the event of continued strong increases in property prices over the medium term.

Public finances have further improved on the back of robust output growth, yet risks of volatility in some forms of tax revenue remain. Overall 2017 tax revenues increased at a healthy rate. Although corporation tax receipts came in better than expected, this was mostly offset by shortfalls against other main sources of tax revenue, such as income tax, excise duties and VAT. Overall government expenditure in 2017 has been within budget allocations. Irish public indebtedness has diminished in recent years, but remains elevated. The strong cyclical situation, coupled with a high degree of volatility in corporation tax revenue and heightened economic uncertainty over the medium-term implies a strong case for broadening the tax base and building fiscal buffers.

Banks continue to improve their resilience amid heightened uncertainty. Improved capital buffers should help them navigate possible impacts stemming from the UK's withdrawal from the EU while continuing to deal with legacy issues. Strong economic growth and investor appetite for Irish assets improve banks' overall asset quality. On 23 June 2017 the government sold 28.75% of its stake in Allied Irish Banks, raising EUR 3.4 billion, the proceeds of which were used to reduce government debt. Although rising property prices are supporting the repair of banks' and households' balance sheets, the sustainability of such developments warrants continued attention. While a recovery in credit demand is observed for certain categories of loans, private debt repayments are still dominant, which makes future profitability less certain. The macroprudential framework is crucial for ensuring households' and banks' resilience in the current housing market dynamics. SME access to finance could be challenged by spillovers on the real sector from the UK. Concerns remain that the draft bill enabling the Central Bank of Ireland (CBI) to cap interest rates on variable rate mortgages, if enacted, could have negative implications for the transmission of monetary policy, financial stability and bank competition.

While notable progress in the reduction of non-performing loans (NPLs) has been made and focus is shifting towards new lending, continued efforts to deal with legacy issues remain necessary. The stock of non-performing loans continued to decline but remains elevated, with the high share of long-term arrears, in particular mortgages, still being a concern. Domestic banks are now being active as sellers and buyers of loan portfolios. While public confidence in the banks has been dented by the mismanagement of a number of tracker mortgages, there is no evidence this has impacted the behaviour of retail customers.

Persistent supply shortages coupled with increasing demand continue to drive strong increases in residential property prices and rents. House prices continued to rise in 2017, with an annual increase of 11.6% in November, moderating from more than a two-year high in September. Rents are above their peak 2008 level. New mortgage credit is starting to increase, albeit from a low base. The government has taken a number of measures to support the recovery of housing supply. Despite recent increases, housing output remains well below the level needed to address long-term housing demand adequately. Residential

property transactions have risen gradually over the past couple of years yet remain subdued overall on the back of the limited housing stock.

Risks for Ireland's capacity to service the European Financial Stability Mechanism (EFSM) and European Financial Stability Facility (EFSF) debt remain low. Market access conditions for the Irish sovereign remain favourable. The debt sustainability analysis shows that the public debt-to-GDP ratio is expected to decrease further in the medium-term but remains vulnerable to economic shocks. The completed early and full repayment of the outstanding IMF loans together with bilateral loans from Denmark and Sweden further reduces Ireland’s interest repayment burden, and smoothens and extends the debt maturity profile. The National Treasury Management Agency (NTMA) plans to maintain strong cash buffers in advance of large redemptions over the medium term, notably in 2019 and 2020.

Ireland’s macro-economic imbalances continue to unwind amid strong economic growth and following policy actions. In February 2017, Ireland was identified as experiencing macroeconomic imbalances, which require specific monitoring in the context of the Macroeconomic Imbalances Procedure. These imbalances are largely legacy issues relating to large stocks of public and private debt and net external liabilities, high levels of non-performing loans and real house price increases. Household debt remained broadly unchanged in 2017. While the situation of non-financial companies is more difficult to interpret given the weight of multinationals on total corporate debt, it is clear that most indigenous firms keep reducing their debt. While the high negative level of net international investment position appears to be driven by factors disconnected from the domestic economy, the external sustainability of the domestic sector is gradually improving due to current account surpluses. The government has taken measures to address public debt and housing supply shortages, but challenges remain. More details are provided in Annex 1 to this report.

The next PPS mission is planned to take place in spring 2018.

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1. INTRODUCTION

Staff from the European Commission, in liaison with the European Central Bank (ECB), undertook the eighth post-programme surveillance (PPS) review mission for Ireland from 28 November to 1 December 2017. Under PPS, the Commission undertakes regular review missions to EU Member States which previously 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 EFSM, EFSF and bilateral lenders.([1]) 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 competent committee of the European Parliament, to the Economic and Financial Committee and to the Irish Parliament.

In line with 2014 Council conclusions ([2]), specific monitoring of the adjustment of macroeconomic imbalances will be undertaken during the PPS mission. Under the 2017 European Semester, the in-depth review (IDR) on the macroeconomic imbalances procedure (MIP) found that Ireland had imbalances that require specific monitoring of the implementation of MIP-relevant country specific recommendations (CSRs) ([3]) and other policies addressing underlying challenges identified as sources of imbalances, such as the housing market. A review of the policy measures undertaken is provided in Annex 1 of this report.

([1]) Under Regulation (EU) No 472/2013, PPS will apply 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 at the earliest.

([2]) See Council conclusions on in-depth reviews (IDRs) 2014 from 6 May 2014.

([3]) https://ec.europa.eu/info/sites/info/files/2017-european-semester-country-specific-recommendations-commission-recommendations-communication.pdf

2. RECENT ECONOMIC DEVELOPMENTS AND OUTLOOK

2.1. MACROECONOMIC TRENDS

The Irish economy continues to expand at a strong pace and growth is expected to remain robust in the short term. In the first three quarters of 2017, Ireland's real GDP grew on average by 7.4% year-on-year (y-o-y), well above the euro area average. GDP growth is projected to remain robust over the next two years but moderate slightly ([4]). However, the national accounts figures remain volatile and heavily influenced by the activities of multinational enterprises operating in Ireland.

New complementary indicators help to shed light on the underlying domestic activity. The Central Statistical Office (CSO) has started publishing an adjusted annual indicator for the domestic economy. Modified Gross National Income (GNI*), adjusts the gross national income (GNI) for the retained earnings of re-domiciled companies and depreciation on foreign-owned domestic capital such as intellectual property (IP) and aircraft for leasing. The domestic demand and Balance of Payments have also been adjusted. These indicators provide useful complementary information to policymakers. ([5])

The domestic economy is expected to maintain its strong momentum. Modified Domestic Demand, a measure of domestic activity that strips out certain effects related to multinationals ([6]), grew at robust rates in 2016, by 4.7% y-o-y, and the first three quarters of 2017, by 4.9% y-o-y, with a strong contribution from construction investment. It is expected to further increase at an average rate of 4% over the next two years. The strong and broad-based growth in employment, in particular full-time employment, reflects also the strength of domestic economy.

Volatile headline investment figures need to be interpreted with caution. Total investment (gross fixed capital formation) in the Irish economy declined by 15.6% y-o-y in the year to September, with an extremely volatile quarterly profile. As in 2016, much of the fluctuation can be attributed to swings in imports of IP services, with an offsetting impact on GDP. Investment in aircraft has also contributed to the swings in total investment.

Evidence suggests that core domestic investment remains strong. The new CSO complementary series for investment, which adjusts for imports of IP and aircraft for leasing, shows that domestic investment is clearly on an upward trend (Chart 2 in Chart 2.1). In particular, the investment in residential property was firm in the first three quarters of 2017 when it grew by 14.9%. The strong momentum is expected to continue in the short term, supported by government policies and strong housing demand. However, the recent weakness in business investment (machinery and equipment excluding aircraft) could be a sign of investors reacting to the uncertainties surrounding the external environment, such as the outcome of the negotiations between the EU and the UK.

The trade figures remain volatile and disrupted by the activities of multinationals in Ireland. Contract manufacturing ([7]) weighed on exports figures in 2017([8]), even though it played a major positive role in Q3-2017. Overall, in the first three quarters of 2017, total exports increased by 5.1% y-o-y, but mostly driven by exports of services. Total imports declined by 5.8% y-o-y held back by extremely volatile imports of intellectual property

([4]) Given the ongoing negotiations on the terms of the UK withdrawal from the EU, projections for 2019 are based on a purely technical assumption of status quo in terms of trading relations between EU27 and the UK. This is for forecasting purposes only and has no bearing on the talks underway in the context of the Article 50 process.

([5]) For more details on the new indicators see Box 1.1. GNI* and other new indicators of Ireland's domestic economic activity, in: European Commission (2018), 'Country Report Ireland 2018', Commission Staff Working Document, forthcoming

([6]) The Modified Domestic Demand, published by CSO, is defined as total domestic demand net of investment in aircraft for leasing and R&D-related intellectual property.

([7]) Contract manufacturing refers to the production of goods abroad on behalf of Irish-domiciled entities for exporting.

([8]) In the first three quarters of 2017, exports of goods, according to the balance of payments (BoP), declined by 0.9% y-o-y. Meanwhile, exports of goods, implied by the international trade figures, increased by 3.3%. This contrast shows that the contract manufacturing, estimated as the difference between exports in total trade balance (BoP) and those shown by the international trade, weighed on total goods exports figures in 2017. For more details on trade indicators and related ownership-based adjustments see CSO publication: http://www.cso.ie/en/releasesandpublications/in/geid/explaininggoodsexportsandimports2012-2016/

services. As a result, a highly positive net external trade contributed significantly to GDP growth in the first three quarters of 2017. Under the technical assumption of no disruption to trading relations between the EU and the UK, exports are projected to increase in line with global trade. Imports are predicted to gather momentum on the back of strong consumer demand, leading to a moderation of the positive impact of net exports on GDP growth.

The labour market performs strongly. The unemployment rate in Ireland fell to 6.7% in 2017 and is expected to decline further in the short term. However, the youth unemployment rate remained high at 14.7%. In the first three quarters of 2017, employment grew by 2.8%([9]), across almost all economic sectors. Over the same period, full-time employment grew by 5.9%, the fastest rate since 1999, and outpacing the growth in total employment as part-time work is being transformed into full-time jobs. Against this background, labour income continues to grow further supported also by an increase in average hourly wages, which grew by 1.3% y-o-y in the first three quarters of 2017.

Consumer price inflation remains subdued, supporting real disposable income. In 2017, HICP inflation rose by only 0.3%. Upward pressure came from increasing energy prices and services. However, this was partly offset by the persistent negative price inflation of goods, driven largely by currency depreciation in the UK, from which Ireland imports approximately 25% of all goods. This negative price impetus is expected to continue in the short term. Prices for services and residential rents are expected to support a gradual pick-up in headline inflation over the medium term.

Residential property prices and rents have accelerated steadily in recent months. House prices grew at an average annual rate of 9.2% over 2013-2016. They continued rising in 2017, with an annual increase of 11.6% in November, moderating from more than a two-year high in September. Rapid price increases are now widespread across the country, although significant regional differences in absolute terms remain. New mortgage credit is starting to increase, albeit from a low base. Residential property transactions remain subdued overall on the back of the limited housing stock. Private rent inflation was 6.1% y-o-y in December 2017, with rents 18.5% above their previous peak level recorded in 2008.([10])

While house prices appear to be in line with fundamental factors, pressures on the market are reducing affordability. Based on some standard indicators, such as price-to-rent or regression-based equilibrium price indicators, prices were not assessed as overvalued in 2016. However, the price-to-income (affordability) indicator has been increasing steadily since 2012 and exceeded its long-term average in the fourth quarter of 2016 ([11]). In addition, affordability metrics vary widely across regions. Such housing market dynamics may weigh on consumption via income effects.

Total returns in commercial real estate (CRE) have moderated recently. Returns have eased back in recent quarters, bringing them more in line with other international markets ([12]). Prime office rents in Dublin were expected to reach EUR 700 per square metre by end of 2017.([13]) Strong response to rising demand for office space is currently underway in Dublin, with new construction expected to add around 10% to the

([9]) ILO definition

([10]) These figures are based on the consumer price private rent index.

([11]) However, Irish prices would still appear to be fairly affordable according to EU standards. This is in line with analysis by the Economic and Social Research Institute, who find that, even with the significant recovery in house prices post-2013, Irish house price-to-income affordability is currently quite low by international comparisons. (McQuinn K. (2017) Irish house prices: Déjà vu all over again?: https://www.esri.ie/pubs/QEC2017WIN_SA_McQuinn.pdf)

([12]) Return is a measure of investment performance. It covers both rental as well as capital elements of a property's value (the percentage change in capital values plus net income accrual, relative to capital employed), and is calculated by MSCI/IPD as reported in Central Bank of Ireland (2017), Macro-Financial Review 2017: II (https://www.centralbank.ie/docs/default-source/publications/macro-financial-review/macro-financial-review-2017-ii.pdf?sfvrsn=5)

([13]) CBRE (2017), *Bi-Monthly Research Report, November 2017* (http://cbre.vo.llnwd.net/grgservices/secure/CBRE%20Ireland%20Bi-Monthly%20Research%20Report%20November%202017.pdf?e=1517225930&h=da501c277fc6dbe9094dae49ae8cdec1)

Table 2.1: Main features of country forecast (based on 2017 autumn forecast)

	2016			Annual percentage change					
	bn EUR Curr. prices	% GDP	98-13	2014	2015	2016	2017	2018	2019
GDP	275.6	100.0	4.0	8.3	25.6	5.1	**4.8**	**3.9**	**3.1**
Private Consumption	90.8	33.0	3.8	2.1	4.2	3.2	**2.6**	**2.6**	**2.4**
Public Consumption	34.1	12.4	1.8	4.1	2.2	5.2	**3.3**	**3.5**	**1.9**
Gross fixed capital formation	87.7	31.8	3.1	18.2	28.2	60.8	**3.5**	**5.6**	**4.6**
of which: equipment	20.5	7.5	6.4	21.6	-0.7	27.9	**-2.7**	**5.7**	**4.5**
Exports (goods and services)	335.0	121.6	7.3	14.4	38.4	4.6	**3.9**	**4.5**	**4.3**
Imports (goods and services)	274.4	99.6	6.8	14.9	26.0	16.4	**2.2**	**4.7**	**4.6**
GNI (GDP deflator)	227.7	82.6	3.6	8.7	16.5	9.9	**3.0**	**3.4**	**2.9**
Contribution to GDP growth: Domestic demand			2.8	5.0	7.9	14.2	**2.4**	**3.0**	**2.5**
Inventories			0.0	1.7	-0.4	0.1	**0.0**	**0.0**	**0.0**
Net exports			1.4	2.3	18.6	-9.2	**2.5**	**0.9**	**0.6**
Employment			1.9	1.7	2.5	2.8	**2.9**	**2.2**	**1.9**
Unemployment rate (a)			7.7	11.3	9.4	7.9	**6.1**	**5.5**	**5.3**
Compensation of employees / head			3.6	1.8	2.1	2.0	**2.6**	**2.5**	**2.4**
Unit labour costs whole economy			1.5	-4.4	-16.6	-0.2	**0.7**	**0.8**	**1.2**
Real unit labour cost			-	-4.1	-22.3	-0.2	**0.2**	**-0.3**	**0.0**
Saving rate of households (b)			-	6.6	6.6	6.3	**6.7**	**6.6**	**6.4**
GDP deflator			2.1	-0.4	7.3	0.0	**0.5**	**1.1**	**1.3**
Harmonised index of consumer prices			2.2	0.3	0.0	-0.2	**0.3**	**0.8**	**1.2**
Terms of trade goods			0.5	-5.2	8.0	2.3	**0.0**	**0.7**	**0.1**
Trade balance (goods) (c)			21.7	20.9	43.3	38.4	**34.3**	**33.2**	**32.7**
Current-account balance (c)			-1.7	1.6	10.9	3.3	**2.9**	**2.5**	**2.3**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)			-1.4	-1.8	10.4	1.5	**1.2**	**0.9**	**0.7**
General government balance (c)			-4.0	-3.6	-1.9	-0.7	**-0.4**	**-0.2**	**-0.2**
Cyclically-adjusted budget balance (d)			-4.1	-4.1	-2.9	-1.7	**-1.3**	**-0.5**	**0.3**
Structural budget balance (d)			-	-4.0	-2.1	-1.9	**-1.3**	**-0.5**	**0.3**
General government gross debt (c)			54.3	104.5	76.9	72.8	**69.9**	**69.1**	**67.2**

(a) Eurostat definition
(b) gross saving divided by adjusted gross disposable income
(c) as a % of GDP
(d) as a % of potential GDP.
Source: European Commission

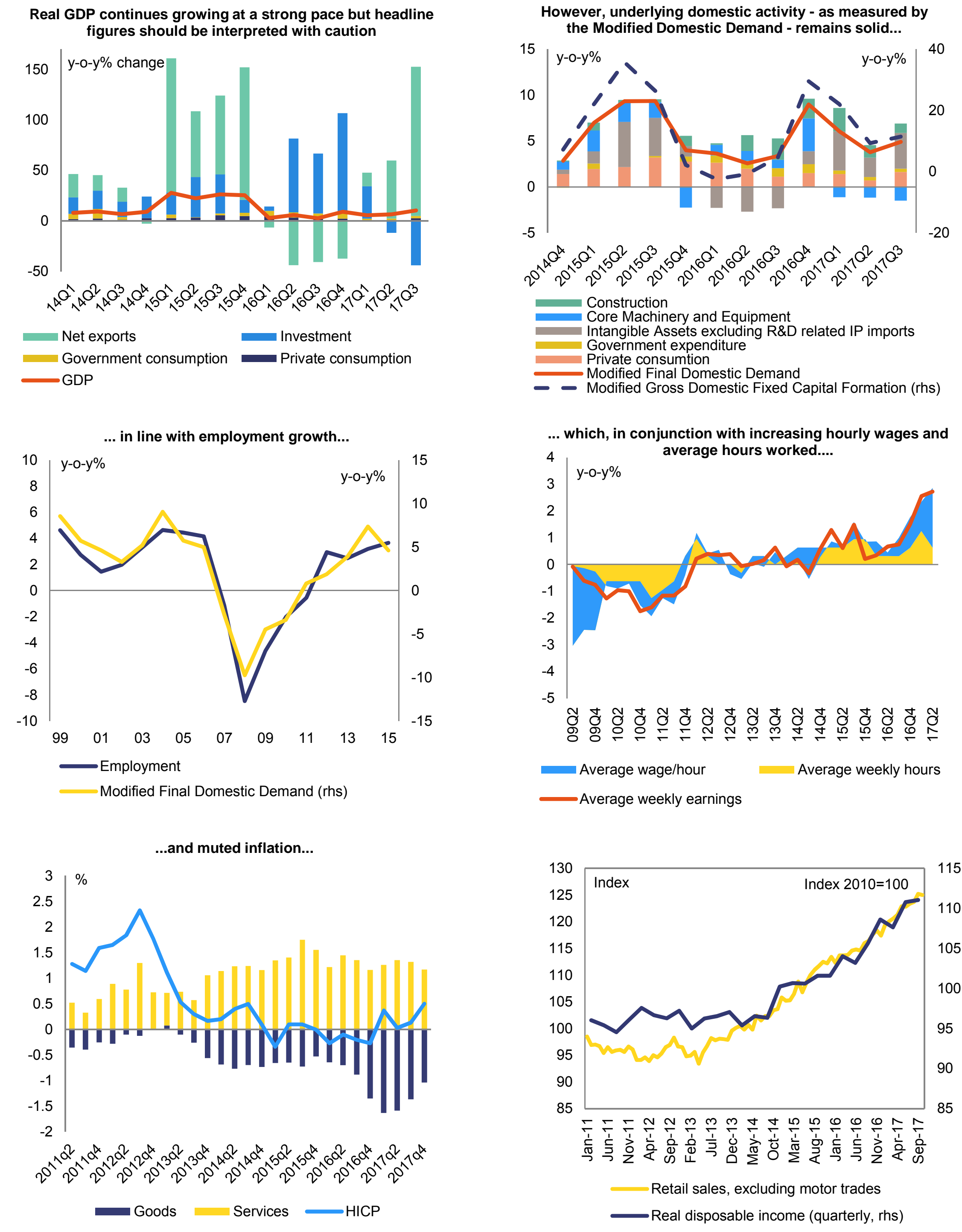
total office stock ([14]). The largest part, around 36%, of office transactions signed in Dublin in the third quarter of 2017 was from financial services, in contrast to previous quarters when the computer and high-tech sector was more prominent.([15])

Risks to the macro-economic outlook are tilted to the downside. External risks relate mostly to the outcome of the negotiations between the UK and the EU and potential changes to the international taxation environment. A large degree of unpredictability remains related to the activities of multinationals with risks being on either side. Internal risks could also arise in the event of continued strong increases in property prices over the medium term. The tightening of the labour market could contribute to the economy overheating in the future.

([14]) CBRE (2017), Ireland Office Major Report: Why Dublin? Why now? (https://researchgateway.cbre.com/layouts/GKCSearch/DownLoadFile.ashx?PublicationID=Mzg1NDA%253D&user=cG9sb25hLmdyZWdvcmluQGVjLmV1cm9wYS5ldQ%253D%253D)

([15]) CBRE (2017), *Ireland Office MarketView Q3 2017* (https://www.cbre.com/report-download?PUBID=694F59B9-CE26-4007-B2DA-736FCB8071DD)

Graph 2.1: **Recent economic developments**



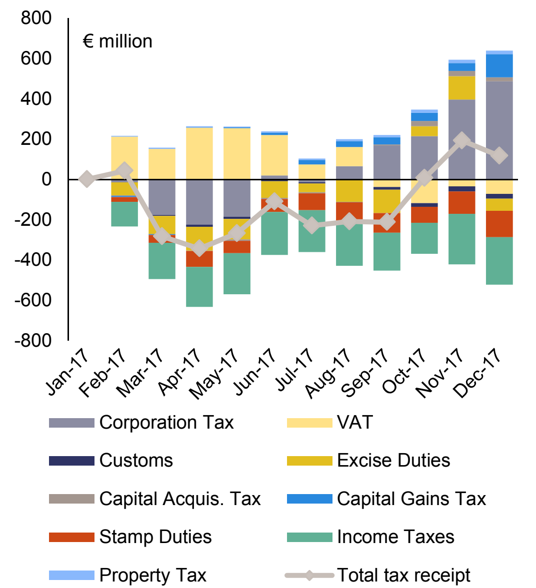
Source: European Commission, Central Statistics Office

2.2. PUBLIC FINANCES

Overall 2017 tax revenues increased at a healthy rate. On a cumulative basis, tax revenues were up 6.0% in 2017 compared to 2016, with corporate tax receipts driving much of the growth (up 11.6% or EUR 850 million y-o-y). Overall tax revenues were on target despite shortfalls against the target in income tax (down 1.2% or EUR 236 million), stamp duties (down 9.8% or EUR 131 million) ([16]), VAT (down 0.5% or EUR 72 million), excise duties (down 1.0% or EUR 60 million) and customs (down 6.7% or EUR 24 million). While these shortfalls were offset by outperformance in other forms of taxes, driven by corporation tax (up 6.3% or EUR 486 million), developments, such as in income taxes, will need to be carefully monitored (Graph 2.2). Income tax PAYE and universal social charge closed the year on target, which means that the income tax shortfall against target was primarily due to a weakness displayed in receipts derived from unearned sources of income and the self-employed.

Government expenditure in 2017 was within budget allocation. Whilst overall spending has remained within the 2017 target, total slippage of approximately EUR 480 million emerged across several departments, such as health provision and housing. This was offset mainly by lower than expected EU budget contribution and debt interest payments. Current primary expenditure was up by 4.0% y-o-y and on profile. Capital expenditure was up 9.3% y-o-y and above profile (EUR 44 million). The overruns were largely accommodated within the supplementary 2017 expenditure announced by the government in November 2017, with increases for individual departments of up to 6%. Almost half of the additional EUR 450 million went to health. This follows several such previous in-year expenditure increases, which have slowed attempts to make public finances more stable in recent years.

Graph 2.2: 2017 tax performance vs target

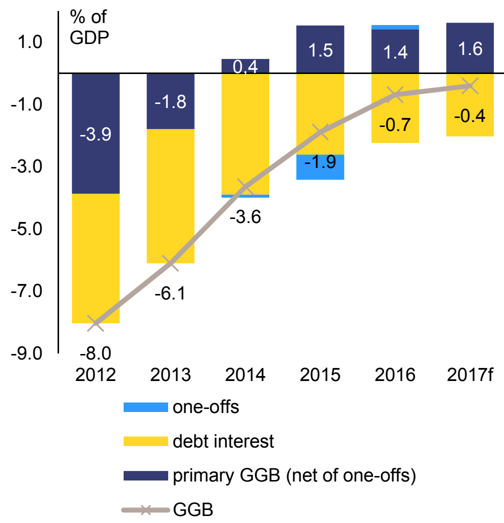


Source: Department of Finance

Public finances continued improving in 2017 on the back of robust output growth. According to the Commission autumn forecast, the general government deficit is projected to have declined to 0.4% of GDP in 2017, an improvement, net of one-offs, of 0.4% of GDP compared to the previous year deficit (2.3). Projections are based on the expectation of a relatively robust increase in tax revenues (5.3% y-o-y) and an increase in current primary expenditure (3.6% y-o-y) which includes public pay increases, the decision to refund water charges and the increased contribution to the EU budget. Projections also consider a marked rebound of public investment (10.1% y-o-y) linked to the housing programme.

([16]) This had been expected by the government and was accounted for in the changes made in Budget 2018 to the 2017 forecast outturn.

Graph 2.3: **Public deficit improvement**



Source: European Commission

2.3. FINANCIAL SECTOR

The domestic banks'([17]) resilience to shocks has further improved, but important challenges remain. The capital positions of Irish banks have strengthened considerably over the past year and net interest margins have remained stable or even expanded, despite lower interest rates. However, legacy non-performing loans (NPLs) and weak credit demand pose constraints on the ability of Irish banks to improve their profits further. The growing uncertainty in the external environment represents an additional challenge.

Sales of legacy assets continue to generate returns for the Exchequer. Despite these conditions, the state-owned Allied Irish Banks (AIB) successfully completed an initial public offering (IPO) in June 2017 with the sale of a 28.75% stake, which raised EUR 3.4 billion. Further divestment remains an option, especially given that the bank has been trading at a premium since the initial flotation. The National Asset Management Agency (NAMA) repaid all of its senior debt in October 2017, three years ahead of schedule. It is projected to wind down in 2020 generating a profit of EUR 3 billion.

Banks have further strengthened their regulatory capital positions, which will help them navigate potential uncertainties ahead. The capital ratios have strengthened over the year to June 2017. As of June 2017, the aggregate CET1 ratio of the domestic banks was 17.3%.([18]) Banks have excess liquidity as a result of deleveraging that took place over the past few years. The liquidity coverage ratio, which expresses the ability to meet short-term obligations, of the top Irish banks was somewhat below their EU peers at 134.8% in June 2017. ([19])

([17]) The term "domestic banks" in this report refers to operating banks that were part of the Eligible Liabilities Guarantee scheme: Allied Irish Banks, Bank of Ireland and Permanent TSB. .

([18]) Source: ECB. Refers to domestic banking groups and stand-alone banks.

([19]) The liquidity coverage ratio is expressed as the relationship between high quality liquid assets (HQLA) and a net liquidity outflow a 30-day time horizon under a liquidity stress scenario. The sampled banks for the reported LCR figures were AIB, BOI, Citibank Holdings Ireland, DEPFA, PTSB, and Ulster Bank Ireland. Source: EBA Risk Dashboard.

Going forward, the main risks remain external, while there is also a need to prepare for upcoming regulatory requirements. The main risk relates to the uncertainties surrounding the UK's decision to withdraw from the EU, relatively weak lending volumes as well as new regulatory measures (i.e. MREL and the introduction of IFRS 9) and the CBI's tracker mortgage examination may lead to some downward pressure on banks' profits. Recent research indicates that tracker mortgages, which still make a large portion of the banks' loan portfolios, restructured NPLs and loans that will be moving from interest-only to principal and interest payments will be particularly sensitive to any interest rate changes.([20]) While the share of fixed mortgages is increasing strongly from low levels, it has to be noted that in the Irish case the rate fixation period is usually very short (up to 5 years), after which the loan converts to a variable rate product.

A recovery in demand for new credit is observed for certain categories of loans. The stock of household credit has been increasing throughout 2017 for the first time after several years of deleveraging. Net loans to Irish households increased by 0.5% y-o-y in September 2017, on the back of increased mortgage borrowing. An uptick in credit demand is also present for certain non-financial corporation (NFC) subsectors. While as a whole, outstanding credit to NFC continues to contract, when excluding for financial intermediation and property-related sectors the loan growth rates are positive. New credit volumes are quite modest when compared to the pre-crisis years. In the mortgage sector, where stronger credit activity could emerge, the limited supply of housing acts as the most significant restraint. New NFC loans larger than EUR 1 million, which are mostly destined to bigger companies, have been growing since end-2015. However, the demand for smaller loans, mostly from SMEs, remains low.

Low credit demand, especially among SMEs, could partly be explained by the comparatively high interest rates charged on new loans. Interest rates on new loans have declined across all sectors. However, recent data show that they have declined much less than in the rest of the euro area,

([20]) McCann, F: Resolving a Non-Performing Loan crisis: The ongoing case of the Irish mortgage market, CBI, 2017.

which has led to the gradual formation of a spread since 2014. In particular, the average interest rates that Irish banks charge NFCs for new loans under EUR 1 million was 4.7% as of October 2017, which was substantially higher than both the averages for all and high NPL countries within the euro area. Similarly, the average interest rate on new mortgage loans was also much higher than in the Eurozone, 3.2% as of October 2017, as opposed to the euro area and high NPL euro area averages of 2.1% and 2.3% respectively.

Rising property prices are supporting the repair of banks' and households' balance sheets. The strong recovery of property prices amid the limited supply has helped a number of households rise out of negative equity. The recovery in housing assets, together with some increase in earnings, strengthens the households' net worth and capacity to repay. On the other hand, the spiralling house prices warrant constant supervisory caution.

While the stock of non-performing loans continued to decline, it remains elevated, with loans to certain categories of firms especially affected. The aggregate NPL ratio of domestic banks stood at 14.4% at the end of June 2017, down from 17.2% in the previous year. The aggregate numbers conceal differences among lenders – in fact, a minor increase in quarterly NPL statistics was the result of a reclassification performed in one of the banks. The overall rate of corporate NPLs declined to 19.1% in June 2017. According to the Central Bank of Ireland the rate of NPLs for SMEs is somewhat higher at 24% with sectors such as hotels/restaurants and transport being particularly indebted. This is especially important in the light of potential Brexit spillovers as these sectors are also among the most exposed to the UK market.

Long-term mortgage arrears continue to represent a substantial portion of the remaining NPL stock. In September 2017, close to 70 000 accounts were in arrears of 90 days or more, with a total balance of EUR 15.4 billion. Of these, over 45 000 (65.0%) or EUR 11.1 billion (71.9%) have been in arrears for 2 years or longer. Many of these loans have been in arrears for more than 5 years. Since their stock started decreasing in mid-2015, long-term arrears have been reducing at a slow pace by an average of EUR 0.8 billion annually. Although the pace has picked up recently, the bulk of long-term arrears will remain unresolved on banks' balance sheets for a long period. Collateral repossessions are still quite rare, with the court proceedings also being impacted by the ongoing tracker mortgage examination (see section 3.2).

Aside from long-term arrears, the sustainability of existing loan restructurings remains a key risk. Recent research from the CBI shows that certain types of restructurings are particularly prone to re-defaults, even after controlling for past defaults.([21]) In particular, the likelihood of full repayment is lowest for solutions involving a temporary payment reduction, both past and current, and in particular for loans that have been temporarily converted to an interest-only loan. In turn, split mortgages have the best performances, with the highest probability of full payment. The research also shows that a substantial proportion of restructured loans, some of which are currently classified as performing, has been subject to temporary arrangements([22]) and will face future instalment increases. In summary, these results highlight that loan restructuring practices may still leave certain underlying vulnerabilities, which may surface if the conditions worsen.

The provisioning levels of Irish banks remain relatively low. The aggregate Irish banks' coverage ratio ([23]) of 32.6% at June 2017 is much lower than that of their EU peers, and has been on a decreasing trend over the past few years. Some of this reduction can be explained by improving economic conditions and in particular the relatively quick recovery of house prices, which has improved collateral valuations. However, maintaining adequate provisioning practices, especially in the treatment of certain types of

([21]) McCann, F.: Resolving a Non-Performing Loan Crisis: The ongoing case of the Irish mortgage market, CBI, 2017.
([22]) The category "temporary payment reductions" includes the conversion of loans to interest-only loans for a pre-specified period, the temporary granting of payment moratoria, loans for which interest payments are deferred to a future date, and temporary interest rate reduction schemes. "Arrears capitalisation" restructuring solutions simply carry forward past-due payments. "Split mortgages" assume losses on one part of the loan and hold the borrower responsible for the rest, usually with some other form of restructuring.
([23]) The coverage ratio refers to provisions as a share of total gross non-performing loans and advances. Source: ECB. Refers to domestic banking groups and stand-alone banks.

restructuring solutions (i.e. split mortgages), remains of importance.

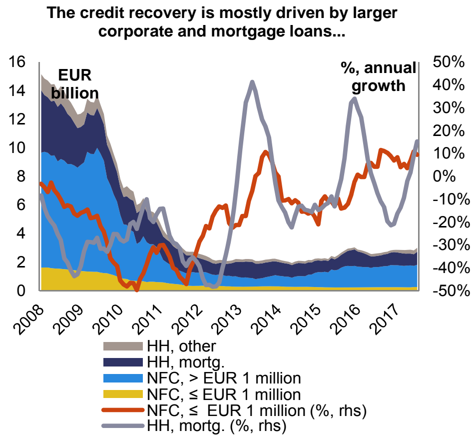
Sales of distressed assets continue to take place in Ireland. Despite major legal obstacles (e.g. slow repossessions), Ireland remains a relatively active market for distressed loan sales, benefitting from global capital linkages. The exiting Danske bank sold a EUR 1.8 billion performing loan portfolio for close to par value while AIB is reported to be preparing the sale of a very large (EUR 3.8 billion notional) non-performing portfolio, Project Redwood, in 2018.

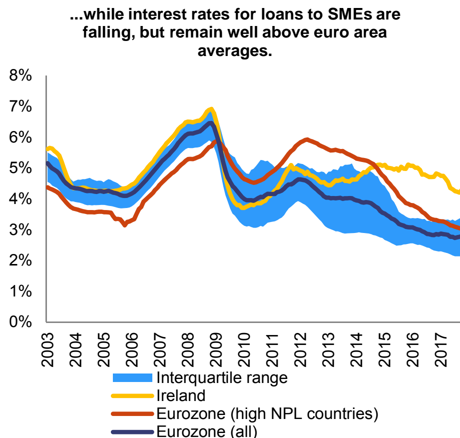
Table 2.2: **Financial sector indicators**

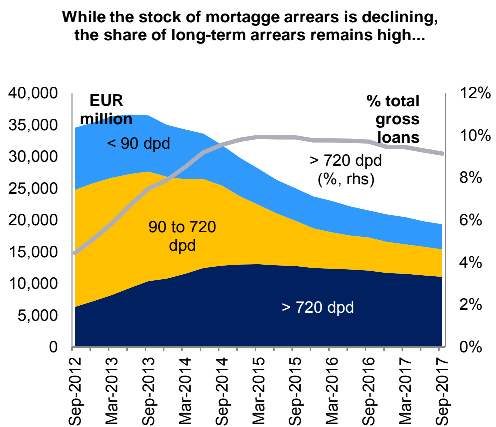
	2014	2015	2016	2017Q2
Non-performing loans	23.9	18.5	15.7	14.4
o/w NFC & HH sectors	25.6	19.9	16.7	15.8
o/w NFC sector	40.3	29.0	21.4	19.1
o/w HH sector	18.1	15.4	14.4	14.3
Coverage ratio	42.6	38.8	35.6	32.6
Loan to deposit ratio	93.4	95.6	94.7	94.2
CET 1 ratio	15.5	14.4	16.8	17.3
Return on equity	7.1	8.1	7.6	8.5*
Return on assets	0.6	0.8	0.8	1.0*

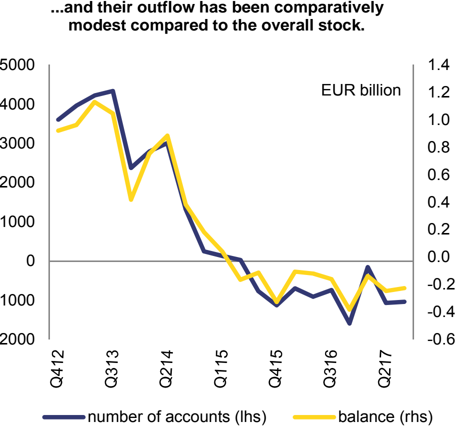
*For comparability purposes, annualised figures are presented.
Source: ECB

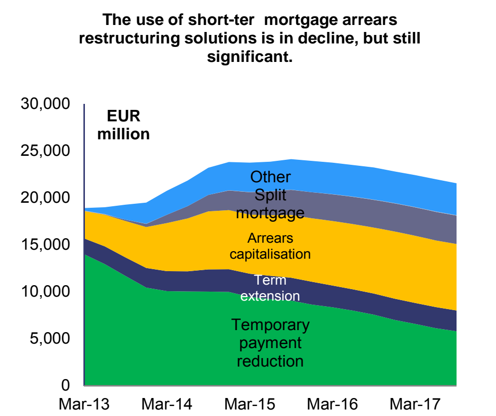
Graph 2.4: **Recent financial developments**

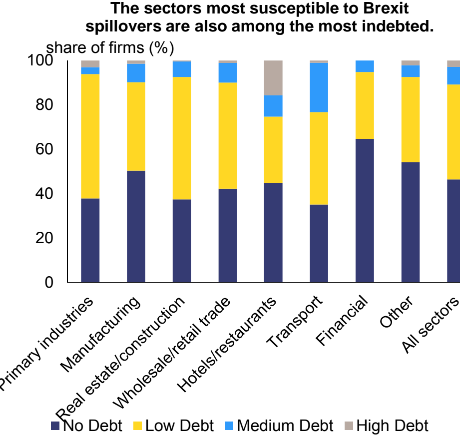












(1) Note: HH - households, NFC - non-financial corporations, dpd - days-past-due
(2) growth rate based on a 6-month moving average
Source: CBI, ECB

3. POLICY ISSUES

3.1. PUBLIC FINANCE

Ireland may not fully comply with EU fiscal rules in 2017 and 2018. The assessment of the 2018 Draft Budgetary Plan ([24]) points to a risk of a significant deviation from the required adjustment path towards the medium-term objective (MTO) over 2016 and 2017 when taken together. ([25]) The Commission autumn forecast projects Ireland to achieve the MTO of a structural balance of -0.5% in 2018. This compares with a projected structural balance of -0.6% based on the 2018 Draft Budgetary Plan. ([26]) The Plan points to a risk of some deviation over 2017 and 2018, when taken together. Specifically, government expenditure, net of discretionary revenue measures and one-offs, is expected to grow above the rates, which would ensure convergence to a balanced budget in structural terms.

Given broadly favourable economic and financial developments, it would seem an appropriate time to boost the shock resilience of public finances. No major changes to the medium-term policy of exhausting all available fiscal space were made in Budget 2018. However, with the government's budget returning to balance, debt ratios on a downward trajectory and near-term interest and growth prospects favourable, Ireland is in a good position to make its public finances more stable over the medium term. However, some past developments have been at odds with this. Within-year expenditure increases, which have mostly gone to towards current expenditure for the health sector, have contributed to limited compliance with fiscal rules.

Increasing capital investment while simultaneously maintaining a sound fiscal stance presents a challenge. Recently, the Irish Fiscal Advisory Council has urged against extra within-year increases in expenditure ([27]). A number of reports, such as those by the CBI and the National Competitiveness Council, have highlighted the considerable challenge facing Ireland in capital spending needed to improve public infrastructure in housing, transport and communications, while operating close to its potential([28]), especially if not offset by countercyclical measures elsewhere. Hence, it remains important to prioritise investment, while using any windfalls gains arising from the strong economic conditions to build up buffers for future shocks or reduce debt at a stronger pace, rather than to fund permanent current expenditure increases. Ireland's bright economic outlook should allow for sufficient space both to pursue prudent fiscal policy, as well as to address infrastructural deficits.

There is scope for a shift towards more sustainable sources of revenue. The main revenue-raising measure ([29]) in Budget 2018 was a tripling of the stamp duty rate on commercial property transactions. However, there are factors beyond the control of the government that impact its final yield, including behavioural changes in response to the tax increase. Similarly, the reduction in capital allowances for intangible assets, although it might help smoothen the corporate tax revenue over time, can be hardly seen as a stable funding source. Graph 3.1 also shows that personal income taxes have overtaken VAT as the single largest source of tax revenue to be raised by the Exchequer, as well as the surge in

([24]) European Commission (2017), Commission Opinion of 22.11.2017 on the Draft Budgetary Plan of Ireland (https://ec.europa.eu/info/sites/info/files/economy-finance/c-2017-8018-en.pdf)

([25]) This requirement refers to the average of the annual deviations of each pillar in two consecutive years. The significant deviation threshold for the two-year average is 0.25% of GDP. The Irish authorities have repeatedly contested what they consider to be the retroactive application to the 2016 budgetary assessment of the systematic exclusion of one-offs from the expenditure benchmark calculation. Not adjusting for one-offs, the two-year assessment would point to some deviation.

([26]) Cyclically-adjusted balance net of one-off and temporary measures, recalculated by the Commission on the basis of the information provided in the DBP, using the commonly agreed methodology

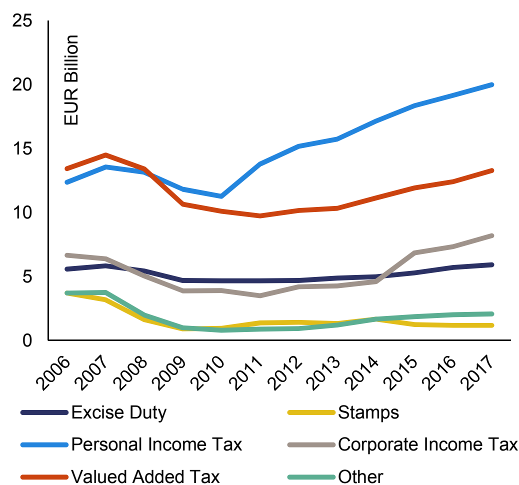
([27]) Irish Fiscal Advisory Council (2017), Pre-Budget 2018 Statement (http://www.fiscalcouncil.ie/wp-content/uploads/2017/09/Pre-Budget-2018-Statement.pdf)

([28]) Central Bank of Ireland (2017), Macro-Financial Review 2017: II (https://www.centralbank.ie/docs/default-source/publications/macro-financial-review/macro-financial-review-2017-ii.pdf?sfvrsn=5)
National Competitiveness Council (2017), *Ireland's Competitiveness Challenge 2017* (http://www.competitiveness.ie/Publications/2017/Competitiveness%20Challenge%202017.pdf)

([29]) Along with changes in some excise duties, the restriction of some capital allowances for corporation tax purposes, the extension of mortgage interest relief, compliance measures and the increase in the National Training Fund levy.

the share of corporate income tax receipts. Strengthening revenue from taxes on consumption and from recurrent taxes on residential property and less reliance on income taxes would, also in line with general OECD tax policy reform recommendations, support the growth orientation of the Irish tax system.

Graph 3.1: Revenue contributions



Source: Department of Public Expenditure and Reforms

While corporation tax revenue has increased considerably in recent years, it is heavily dependent on a small number of taxpayers. Recent reports of decisions by some large multinational companies to restructure their business in Ireland demonstrate that international tax reform may lead to changes in business models of multinationals. This highlights how Ireland's exposure to international tax changes and the concentration of corporation tax receipts among a fairly small group of companies ([30]) remains a vulnerability, and how it is essential that the overall tax base is broadened. In this context, it is worth highlighting the role that corporation tax has played in driving tax revenue in recent years, exposing the deficit outturn to adverse developments.

A broader personal income tax base would improve revenue stability in the face of economic volatility. The government has announced that a working group would be created in 2018 to plan the amalgamation of universal social charge (USC) and pay related social insurance (PRSI) over the medium term in order to ensure Ireland's personal tax system is competitive and resilient in the future. EUROMOD ([31]) simulations have demonstrated that eliminating the USC would narrow the tax base. Recovering a substantial part of subsequent revenue losses would require lowering the entry-point to the tax system via a reduction of the tax credits. ([32]) Building on this, updated EUROMOD analysis confirms that the personal income taxation in Ireland, in particular, already has a fairly narrow base. Budget 2018 includes increases to the point of entry to the standard rate of income tax and to two income tax credits, and reductions to two of the middle rates of USC and increasing the ceiling for one of them. In line with previous government announcements, the USC reductions are targeted at low- to middle-income earners. The EUROMOD simulation also shows that the weight of the tax credits, tax thresholds and tax expenditures on the Irish tax system ([33]) has already increased in the last years, by 1.2% of total possible tax revenue between 2015 and the 2018 Budget. In terms of total tax revenue, the 2018 reforms alone represent a loss of almost 2%. ([34])

Demand for spending increases may pose a risk to Ireland's public finances. All policy areas received expenditure increases in Budget 2018. It is, nevertheless, forecast that expenditure will decline as a share of GDP over the period 2016-

([30]) The top ten corporation tax payers accounted for 37% of total corporation tax receipts in 2016.

([31]) EUROMOD is the tax-benefit microsimulation model for the EU. It is used to simulate the benefit entitlements and tax liabilities (including social security contributions) of individuals and households according to the tax-benefit rules in place in each Member State. The simulations are based on representative survey data from the European Statistics on Income and Living Conditions (EU-SILC) and cover the main elements of direct taxation, social contributions and non-contributory benefits. It is conducted by the European Commission (Joint Research Centre).

([32]) See European Commission Economic Brief 028/July 2017 by McQuade P., Riscado S. and Santacroce S. (2017), *Personal income tax in Ireland: the future of the Universal Social Charge*

([33]) The weight of tax expenditure is assessed by comparing the actual system with one which excludes main tax credits and tax expenditures (i.e. tax credits, reliefs, allowances) and the income tax entry threshold. EUROMOD inflates/deflates earnings whenever the year of the survey data does not coincide with the tax system year. This exercise did not imply any normative approach to the benchmark Irish tax system when eliminating tax allowances and tax credits.

([34]) Loss of total tax revenue is assessed by comparing the actual Budget 2018 system with the actual 2017 system.

2021. However, this is contingent on moderate absolute spending growth in the later years. EUR 180 million has been committed for the new public sector pay agreement for 2018. In case the annual rate of increase in staff numbers continues to be in the range of 2-3% ([35]) over the medium term and extra revenue is not raised, the pay increases may have a perceptible impact, particularly in the health sector.

The planned Rainy Day Fund could contribute to prudent management of public finances. This hinges on several design features. To this end, the government has prepared a paper for a consultation with the Parliament. The fund needs to account for the EU fiscal rules and the fact that they already allow the automatic stabilisers to provide counter-cyclical fiscal support to the economy. The consultation paper indicates that, to address this, the fund would primarily operate along the lines of a defined-purpose instrument. ([36]) However, the question is raised whether the fund should be deployed as a stabilisation mechanism, additional to the one built in the EU fiscal rules, in the event of particularly severe economic shocks beyond "normal" cyclical conditions. A further consideration, acknowledged in the consultation paper, is striking a sensible balance in the design of resourcing and withdrawal triggers. Certainty provided by rule-based triggers set in the legislation has to be balanced against flexibility provided by triggers subject to ad-hoc decisions. Finally, it is important to bear in mind a possible trade-off with faster public debt reduction.

3.2. FINANCIAL SECTOR POLICIES

While notable progress in NPL reduction has been made and focus is shifting towards new lending, continued efforts to deal with legacy issues remain necessary. Irish banks, however, need to reinforce efforts to ensure that they can withstand any possible deterioration in the economic outlook. Potential risk channels include difficulties of customers exporting to the UK and fluctuations in UK asset valuations.

([35]) Budget 2018 acknowledges that: “Since the end of the moratorium, public service numbers have grown by more than 3 % per year on average […]".
([36]) I.e. address only specific events or shocks rather than the impact of the cycle.

Strong economic growth, restructuring efforts and investor appetite for Irish assets improve banks' overall asset quality. Policy measures played an important role in this. For instance, recent CBI research shows a significant move from temporary to more lasting mortgage arrears restructuring since the introduction of Mortgage Arrears Restructuring Targets (MART) in 2013. A targeted use of write-offs for non-recoverable NPLs would be advisable where possible, especially for long-standing arrears where other strategies did not yield success. Securitisation and sales are further avenues for de-risking the banks' balance sheets and the banks are starting to use them more frequently. As there is no single solution to NPL reduction, activities need to be pursued on multiple fronts to "chip away" from the NPL stock.

Public initiatives geared toward private debt resolution yield mixed results. On one hand, the number of applications for personal insolvency has visibly increased since the launch of the *Abhaile* Aid and Advice scheme for distressed mortgage borrowers in the second half of 2016; the number of applications in the first half of 2017 alone almost matched the 2016 total (of about 2,500 applications). On the other hand, the number of concluded arrangements seems to be in decline currently, due to a more frequent rejection of the proposed insolvency arrangements by the creditors. A review of the mortgage-to-rent scheme amended its eligibility criteria and administration scheme to enable more properties to qualify and to make the scheme more flexible and accessible to borrowers

Banks' are preparing for the new regulatory requirements. Although the minimum requirement for own funds and eligible liabilities (MREL) for banks is yet to be set by the Single Resolution Board (SRB) on a case-by-case basis, the banks are already aware of its approximate range. The impact of the upcoming IFRS9 implementation is expected to be manageable. The Single Supervisory Mechanism (SSM) draft guidance on NPL provisioning requirements for loans, still in the making, could impact the current provisioning practices.

The macroprudential framework is crucial for ensuring households' and banks' resilience amid the housing market dynamics. The 2017

review of mortgage-related measures left the existing macroprudential framework essentially unchanged, apart from a minor modification restricting the banks' discretionary buffer above the 3.5 loan-to-income ratio to 10% for subsequent buyers.([37]) In addition, the CBI published a comprehensive Systemic Risk Pack to monitor systemic risk, including by following medium-term macroprudential objectives across a series of indicators. While limited supply is still likely to pose the greatest constraint to mortgage credit volumes in the near to medium term, the macroprudential rules can also indirectly affect (median) loan sizes and by consequence, curb prices.

An operational credit register is set to be in place in 2018. A well-functioning credit register is an important factor in ensuring prudent lending. It is also a prerequisite for potential future considerations of debt-to-income (DTI) or debt-service-to-income (DSTI) limits within the macroprudential framework, as it allows gathering information on all relevant exposures of each unique borrower. The register is expected to become operational for customers and credit institutions in early 2018. It will cover credit outstanding at June 2017 and loans originated thereafter.

Public confidence in the banks has been affected by the treatment of a number of tracker mortgages. The CBI initiated a systemic examination of tracker mortgage-related issues with the view of ensuring the identification of and redress to borrowers who were wrongfully taken off the tracker interest rate or received an incorrect margin on the tracker. As of mid-December 2017, 33 700 impacted accounts have been identified across several lenders, and EUR 297 million have been paid as redress and compensation. The issue has attracted public attention. The impact on the banks' profits of the amount of provisions that has had to be set aside towards redress for customers on the banks' profits will be dependent on the final outcome of the examination.

([37]) Under the revised rules only 10%, rather than 20%, of mortgages issued yearly by each bank to subsequent buyers can have a loan-to-income (LTI) ratio above 3.5. This is in contrast to 20% for first-time buyers.

3.3. PROPERTY MARKET AND CONSTRUCTION

A shortage of residential properties exerts upward pressure on house prices and rents. The draft National Planning Framework projects a total requirement to accommodate 550 000 additional households by 2040. Other estimates of housing demand range from 23 000 (rising to 32 000 by 2024) ([38]) to 50 000 ([39]) new homes per year. Precise estimates of the extent to which supply is falling short of demand is difficult given that official figures, based on new connections to the electricity grid, have been cast into doubt ([40]). However, alternative indicators, based on planning permissions, registrations (Graph 3.2) or energy rating statistics, consistently indicate that new housing, while steadily increasing, is still falling short of the level needed to catch up with long-term housing demand.

Housing policy needs to be underpinned by a concrete and coherent regulatory framework that facilitates higher densities. The draft National Planning Framework has indicated that, to avoid urban sprawl and the demands that it puts both on the infrastructure and environment, increased residential density is required in the urban areas([41]). Although the share of apartments increased from 2011 to 2016, semi-detached homes still represented most (41.2%) of new completions in 2016. Apartments represented only 13.8% of the new buildings, despite the need for more one- and two-bedroom apartments.

Some restrictions to apartment building can make it less affordable and attractive to invest in housing. The government has published draft guidelines including measures reducing some restrictions, such as the car parking space and dual aspect requirements. The Society of Chartered

([38]) Duffy D., D. Foley, N. McInerney and K. McQuinn (2016), *Demographic Change, Long-Run Housing Demand and the Related Challenges for the Irish Banking Sector*, The Economic and Social Research Institute (ESRI) (https://www.esri.ie/pubs/CB201617.pdf)

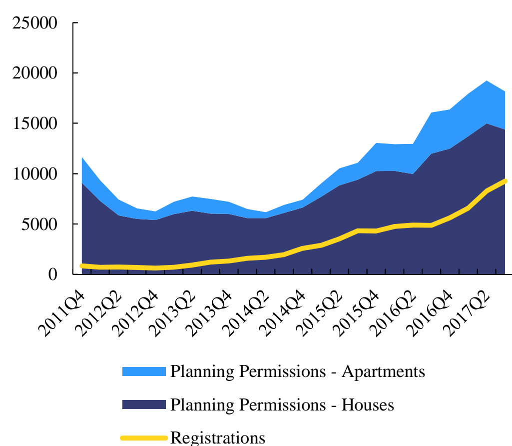
([39]) Lyons R, (2017), *How to Build Enough Homes* (http://www.ronanlyons.com/category/blog/propertymarket/)

([40]) Estimations based on connections to the electricity grid sometimes overestimate housing completions due to problems such as double-counting.

([41]) Government of Ireland (2017), *Ireland 2040 Our Plan: Draft National Planning Framework* (http://npf.ie/wp-content/uploads/2017/10/Ireland-2040-Our-Plan-Draft-NPF.pdf)

Surveyors Ireland estimates that the delivery of affordable medium rise apartment buildings in Dublin is not commercially viable. However, there is limited agreement at this juncture on the elements of the Irish cost base that would be inconsistent with those in other countries. A government working group is conducting its own analysis of construction input cost, together with a separate independent report based on an international cost comparison.

Graph 3.2: Residential construction activity (rolling annual total)



(1) Planning permissions are not necessarely the best predictor of actual output, but rather provide some indication of future building intentions
Source: CSO

In Budget 2018, the government announced it will ramp up its housing development ambitions via a dedicated fund. Market participants have pointed out that banks would be lending money only for developments of up to 50 apartments. Overall, developers may still be struggling to adjust to equity funding. Up to EUR 750 million of the existing Ireland Strategic Investment Fund is being made available for a new dedicated fund (Home Building Finance Ireland) to provide financing on market terms to viable residential development projects, whose owners are having trouble obtaining funding. This would increase the availability of debt-based financing.

It is central to continue monitoring the price of new buildings. A *Help-to-Buy* scheme was introduced in the 2017 Budget, aimed at assisting first-time buyers to buy or build a new house or apartment. Home ownership continued to decline in Dublin and across the country in the first six months of the year despite the introduction of the scheme in January 2017. So far CSO data on median house prices do not show a higher increase in prices in the "first-time buyer of new units" category than for the overall first-time buyer portion of the market since October 2016 ([42]). This is broadly in line with the formal review of the scheme, published along the Budget 2018. The review noted that there were legitimate concerns that the measure could push up prices, but found no evidence of this to date. It also found that the need for the scheme may be reduced for some buyers as a result of the change in CBI's prudential rules. During the mission, the government confirmed that it will continue conducting regular reviews of the scheme, yet does not envisage any changes to date so as to ensure certainty.

The acute problems in the Irish housing market require an acceleration of supply not only by the private, but also public sector. To that end, Budget 2018 included a target of building some 3 800 new social houses in 2018. An additional EUR 500 million was allocated in this budget to increase, by 2021, the total provision of newly built social houses by 3 000, bringing the new target of social homes in the Action Plan for Housing and Homelessness to 50 000 (of which 33 500 through construction). This followed a government announcement of a change in policy so that local authorities move from buying to building new homes.

The last few years have seen a sustained recovery in the commercial property market. While office take-up in Dublin during the third quarter of 2017 was more subdued, it followed a very impressive first half of the year ([43]) on the back of the growth of existing businesses. An increase in the stamp duty rate on the sale of commercial property from 2% to 6% may lead to end of 2017 returns moderating. In terms of risks to the banking sector, while the value of commercial property loans held by retail banks has been decreasing steadily in value terms, the value

([42]) There are limitations to the use of available statistics on residential property prices for assessing the impact of the scheme, including the fact that the published data is likely to reflect some transactions where the prices where agreed some months previously.

([43]) CBRE (2017), *Ireland Office MarketView Q3 2017* (https://www.cbre.com/report-download?PUBID=694F59B9-CE26-4007-B2DA-736FCB8071DD)

is still elevated. This leaves these banks exposed to adverse market developments.

4. SOVEREIGN FINANCING ISSUES

Sovereign financing remains comfortable. At end-2017 the Exchequer had EUR 10.5 billion in cash and liquid assets. The sale of part of the State's shares in the Allied Irish Banks in June raised EUR 3.4 billion. The National Treasury Management Agency (NTMA) raised EUR 15.75 billion in 2017 via benchmark bond sales, taking it beyond the EUR 9-13 billion range it targeted at the start of the year. This was to facilitate the early repayment of IMF, and Swedish and Danish bilateral loans. The NTMA also raised an extra EUR 610 million in its first-ever sale of inflation-linked bonds. The NTMA plans to issue EUR 14-18 billion in bonds in 2018.

Euro area sovereign bond yields remain low. The NTMA in January 2018 raised EUR 4 billion through the syndicated sale of a new 10-year benchmark at a yield of 0.94%. Also as consequence of low yields, total interest payments by the general government have continued to decrease as a share of GDP. According to the Commission autumn 2017 forecast, interest expenditure in Ireland is expected to fall from 2.2% of GDP in 2016 to 2.0% in 2017 and is projected to decrease further next year, to 1.8% of GDP, well below the 4.3% recorded back in 2013 at the peak of the euro area sovereign debt crisis. However, when measured as a share of GNI*, interest expenditure still amounted to more than 3% in 2016.

Irish public indebtedness had diminished in recent years but remains elevated. In nominal terms, Ireland's public debt peaked at EUR 215 billion (or 120% of GDP) at the end of 2013, a five-fold increase from the levels immediately preceding the crisis. Since then, Irish public debt as a share of GDP has significantly declined, reaching 72.8% in 2016, in particular on the back of strong GDP growth. However, a range of other metrics shows that Ireland's stock of public debt remains high by historical and international standards (see Annex 1).

Public debt is largely long-term. At the end of 2016, public debt amounted to EUR 201 billion, of which 90.9% ([44]) had an average remaining maturity of more than one year. However, an amortisation hump of bonds and UK bilateral loans, amounting to around EUR 35 billion (or average annual financing need of around 6% GDP), will arise in 2019 and 2020. The redemption profile of EFSF and EFSM loans currently extends until 2042, with the next principal repayment due in 2018. However, the 2018 EFSM maturities are expected to be refinanced, owing to the maturity extensions granted in 2013 (Graph 4.1) ([45]).

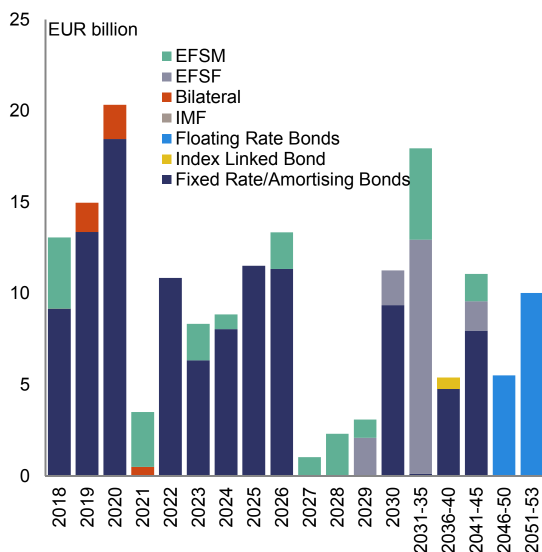
The decision to repay, early and in full, some outstanding programme debt will reduce the interest repayment burden. The NTMA has repaid, on Ireland's behalf, the outstanding IMF loans, together with the bilateral loans from Denmark and Sweden, early and in full ([46]). They have made use of the currently beneficial market conditions and healthy cash position to improve Ireland's debt sustainability. According to the NTMA, these early repayments have the potential to generate interest savings of around EUR 150 million over the remaining life of the loans. They also provide an opportunity to further smoothen and extend the debt maturity profile.

([44]) European Commission (Eurostat)

([45]) The average maturity of Ireland's EFSM loans (calculated from original loan disbursement) is now 15.4 years, reflecting the lengthening of Ireland's first EFSM loan (EUR 5 billion) in late 2015. A decision to further extend EFSM loans has to balance the advantage to lock in currently low interest rates with reduced refinancing options in the future if the average maturity of EFSM loans comes close to the agreed maximum average maturity of 19.5 years.

([46]) The European Commission and EFSF have approved Ireland's request to waive their rights under the mandatory proportionate prepayment clause of the EFSM Loan Facility Agreement (Article 7(3)) and of the EFSF's Master Financial Assistance Facility Agreement (Clause 7(2)), and equivalent provisions under the EFSF's Loan Facility Agreement (Clause 6(2)), and first and second Financial Assistance Facility Agreements with Ireland (Clause 6(2) of each such agreement), in order to repay the outstanding loans to the IMF, together with the bilateral loans from Denmark and Sweden, early and in full, without making a simultaneous proportionate prepayment to the EFSF or EFSM. Ireland's outstanding IMF loans stood at SDR 3.8 billion (circa EUR 4.5 billion) corresponding to 109% of Ireland's IMF quota, while the bilateral loans from Sweden and Denmark stood at EUR 0.6 and EUR 0.4 billion respectively.

Graph 4.1: **Long-term marketable and official debt repayment schedule (end-December 2017)**



(1) The figures in the table are unaudited figures and include the effect of currency hedging transactions. Rounding can affect totals
(2) EFSF loans reflect the maturity extensions agreed in June 2013
(3) EFSM loans are also subject to a seven year extension. It is not expected that Ireland will have to refinance any of its EFSM loans before 2027. However the revised maturity dates of individual EFSM loans will only be determined as they approach their original maturity dates. The table and graph above reflect both original and revised maturity dates of individual EFSM loans
(4) While the principal repayment of index linked bonds will be linked to the Eurostat Harmonised Index of Consumer Prices (HICP) for Ireland, excluding tobacco, it is protected against a fall in the index over the life of the bond.
Source: National Treasury Management Agency

ANNEX 1
Specific monitoring of macroeconomic imbalances

In February 2017, Ireland was identified as experiencing macroeconomic imbalances in the context of the MIP ([47]). The imbalances involve vulnerabilities from large stocks of public and private debt and net external liabilities, despite improvements in flow variables, high levels of non-performing loans and house prices increases.

The Country-Specific Recommendations under the European semester provided guidance for the policy follow-up. These recommendations concern a wide range of policy domains: (CSR1) the sustainability of public finances including limiting the scope and the number of tax expenditures and broadening of the tax base, (CSR2) better targeting the government expenditure and (CSR3) reduction of non-performing loans. All recommendations were considered to be MIP-relevant – in the case of CSR2 the section on government expenditure.

This section provides an overview of the state of play regarding progress with policy implementation to address imbalances as identified under the MIP framework. In order to avoid an overlap of surveillance processes, it does not provide an assessment of fiscal targets.

A1.1. EVOLUTION OF IMBALANCES

The strong momentum in the Irish economy is expected to continue in the short term, but external risks remain tilted to the downside. In the first three quarters of 2017, Ireland's real GDP grew on average by 7.6% year-on-year (y-o-y), well above the euro area average, and is projected to further expand by 3.9% in 2018 and 3.1% in 2019([48]). However, the national accounts figures remain volatile and heavily influenced by the activities of multinational enterprises operating in Ireland. The strong and broad-based growth in employment, in particular full-time employment, reflects the strength of domestic economic activity. External uncertainties persist and relate primarily to the outcome of the negotiations regarding the UK's exit from the European Union and potential changes to the international taxation environment. Risks could also arise in the event of continued strong increases in property prices over the medium term.

Irish public indebtedness decreased in recent years, but remains elevated. Irish public debt as a share of GDP has significantly declined, reaching 72.8% in 2016, in particular on the back of strong nominal GDP growth. However, in the Irish context, GDP overstates the actual size of the domestic economy. When measured as a share of GNI*, a complementary adjusted measure for the GNI which strips out the effect of multinationals ([49]), public debt amounted to 106% in 2016. The Draft Budgetary Plan estimates gross debt to fall to 70.1% of GDP in 2017 and to reach 69.0% in 2018, contingent on still robust GDP growth and the realisation of primary budget surpluses. This is broadly in line with the Commission 2017 autumn forecast.

Private sector debt continues to represent an imbalance in stock terms, while the underlying flows signal continued deleveraging. A large part of the stock of private debt in Ireland is attributed to multinational corporations, which makes the underlying domestic trends harder to grasp based on headline numbers. There is continued evidence that domestic economic actors are overall still deleveraging, with some credit recovery happening in the corporate and mortgage segments. The rise in housing prices increased the net worth of households and reduced the number of those in negative equity, but specific categories of borrowers remain particularly vulnerable.

Persistent supply shortages coupled with increasing demand continue to fuel property prices. Real house prices grew by 6.6% in 2016 after two years of already strong progression.

([47]) This annex presents developments relevant to the analysis of macroeconomic imbalances and related policy implementation, and therefore might overlap in some respect with the other chapters of the post-programme surveillance report.

([48]) Given the ongoing negotiations on the terms of the UK withdrawal from the EU, projections for 2019 are based on a purely technical assumption of status quo in terms of trading relations between EU27 and the UK. This is for forecasting purposes only and has no bearing on the talks underway in the context of the Article 50 process.

([49]) GNI* - Modified Gross National Income, was first published by the Irish Central Statistical Office in July 2017. GNI* adjusts gross national income (GNI) for the retained earnings of re-domiciled companies and depreciation on foreign owned domestic capital such as intellectual property (IP) and aircraft for leasing in an attempt to discount the effects of multinationals on the Irish GDP http://www.cso.ie/en/releasesandpublications/er/nie/niear2016/.

House prices continued rising in 2017 (see Section 2.1). House prices do not yet seem to be overvalued, but affordability may become a concern. Supply shortages remain the prime driver of the increase in house prices and rents. While supply is forecast to fall short of demand for some time, construction activity is gaining momentum (see Section 3.3).

NPLs are reducing as a result of debt restructuring activities and portfolio sales, but remain high. The stock of NPLs kept decreasing over the course of 2017, albeit at a slower pace than seen before. The aggregate NPL ratio stood at 13.9% at the end of September 2017, down from 16.9% one year prior. The NPL reduction results from a combination of restructuring activities and portfolio sales, with varying degrees of success among individual banks. The level of bank provisions against non-performing loans is among the lowest in the EU, and declining. The average coverage ratio of Irish banks was 33% at June 2017, compared with the 45% EU average. While some provision releases are linked to the distressed debt resolution activities and domestic real estate price increases, it is important for them to remain at prudent levels. Continued challenges are posed by long-term arrears (over 2 years past due) that account for more than half of total mortgage NPLs and more than a third of total NPLs.

A1.2. POLICY MEASURES TAKEN TO ADDRESS MACROECONOMIC IMBALANCES

To increase the resilience of public finances

Some measures have been introduced to accelerate the reduction of public debt. In Budget 2017, the authorities indicated a new debt-to-GDP target of 45%, to be achieved by the end of the next decade. More recently, the government has introduced an intermediary target of 55% until its major capital projects are completed. Income from the sale of government's shares in state-owned banks has been used to reduce the debt. By the same token, the redemption by the National Asset Management Agency of the final EUR 500 million of the government-guaranteed debt, three years ahead of the target, marks another important step toward restoring full financial market confidence in the Irish sovereign. In December 2018, the Irish authorities repaid the outstanding IMF loans, together with the bilateral loans from Denmark and Sweden, early and in full.

Despite some advances, details of the announced Rainy Day Fund remain pending. The 2016 Summer Economic Statement outlined that, once the medium-term objective (MTO) of a structural deficit of 0.5% of GDP was achieved, a Rainy Day Fund would be established. The fund could contribute to more sustainable growth, acting as a shock absorber and work as a reserve against future contingencies. A consultation paper was published in October 2017 with the Budget and has been laid before the Parliament.

As for limiting the scope and the number of tax expenditures and broaden the tax base, the measures outlined in Budget 2018 are mixed. Some of the measures in the Budget do not contribute to expanding the tax base, such as the increases to tax credits for self-employed and home carers, the creation of a stamp duty refund scheme for residential land, the reduction from seven to four years of the holding period to qualify for the capital gains tax exemption on certain property assets and the tapered extension of mortgage interest relief for the remaining recipients. Conversely, the reduced cap of 80% on the amount of capital allowances for intangible assets and the introduction of a new tax on sugar-sweetened drinks can potentially broaden the tax base. Nevertheless, Budget 2018 appears to fall short on the overall policy goal of reducing revenue volatility.

Efforts to improve the quality and effectiveness of public spending have also been made. Public investment continues to recover while addressing key infrastructure bottlenecks. In the August 2017 mid-term review of the Capital Investment Plan, the government allocated additional public investment which would bring capital expenditure to 2.3% of GDP in 2021, from an average of 1.9% over 2013-2016. The government's capital allocation for 2018 represents an increase of more than 17% compared to previous year's capital expenditure. Half of this increase has already been allocated to address shortages in social housing. Other prioritised areas in the Investment Plan are transport, water infrastructure, education and healthcare, given the impact of population growth and ageing on these sectors. The ongoing spending review process is expected to enhance the quality

of expenditure. In its first three-year cycle (2017-2019), it has focussed on specific critical spending areas, representing around 30% of current government expenditure, such as drug costs in the health sector, disability and employment programmes in the area of social protection, and public transport. This review process, while going in the right direction with a view to optimise spending allocations in the priority areas, might not be sufficient as significant spending savings are not envisaged given demographic developments in the country (with a still young but rapidly ageing population).

To reduce the stock of non-performing loans (NPLs)

The banks are submitting their NPL reduction plans to the supervisor for assessment of viability and level of ambition. A number of banks have been asked to revise their initial plans. While banks continue to engage their debtors in restructuring arrangements, insolvency procedures, court and out-of-court arrears resolution avenues remain under-utilised. The number of personal insolvency applications has increased since the introduction of the *Abhaile* aid-and-advice scheme. However, there has been an increase in creditors' rejections of the proposed insolvency arrangements, which transfers the cases to court procedure and results in a reduction of concluded arrangements.[50] Collateral repossessions are still quite rare, with the court proceedings also being impacted by the ongoing tracker mortgage examination.

The credit register should become fully operational during the first quarter of 2018. The long-awaited register should become available to customers and credit institutions at the same time. It will cover credit outstanding as of June 2017 and all credit originated thereafter.

To monitor developments in the housing market

The 2018 Budget has anticipated a number of extra measures aimed at addressing the housing shortage, including social homes. The government intervenes via several programmes to help those who cannot provide for their own accommodation needs, such as a Homeless Assistance Payment Scheme. The 2018 Budget anticipated increasing the scheme by EUR 149 million in 2018. This is expected to enable an additional 17 000 households to be supported and accommodated in 2018. The budget includes a target of building some 3 800 new social houses in 2018. An additional EUR 500 million is allocated to increase the total provision of newly built social houses by 2021 by 3 000, bringing the total target of social homes in the Action Plan for Housing and Homelessness to 50 000 (of which 33 500 through construction). However, this takes time and so far only 1 106 new social homes have been completed.

An appropriate supply response requires coherent and concrete action, including on infrastructure and planning system. To this end, a new National Planning Framework is intended to replace the 2002 National Spatial Strategy and has recently completed its public consultation phase. This could facilitate a more stable housing market by enabling a coherent spatial distribution of housing and infrastructure. Approval has been granted for 34 public infrastructure projects across 15 Local Authority areas as part of the Local Infrastructure Housing Activation Fund. A new planning permission process to fast track large scale developments entered into force in July 2017. The publication of the Housing Land Map included an announcement that 2 000 hectares of land in state/semi-state ownership would be made available for residential development to help boost housing supply. The 2018 Budget announces that up to EUR 750 million of the Ireland Strategic Investment Fund is being made available for financing commercial investment in housing via a new dedicated fund. Changes to the capital gains tax are expected to contribute to increasing supply. The budget also signals an increase in the vacant site levy. While this would also encourage builders to use development land, in practice the increase will not have an effect until 2019. While such tax measures could address speculation, they may not

(50) Court reviews confirm the creditors' rejection in approximately 75% of the cases. Anecdotal evidence suggests that, as the mortgage arrears resolution process advances, the remaining are the more difficult cases, where the arrears amounts are very large and creditors become reluctant to accept insolvency arrangements that can involve a large write-off of debt.

address other factors sometimes cited as a significant barrier to new housing delivery, such as high cost. The government has published draft guidelines including measures reducing some key restrictions to apartment building, to make it more attractive and affordable, such as the car parking space requirement.

The government is aiming to incentivise commercial property market developers to shift their attention to residential construction. The 2018 budget includes an increase in the level of stamp duty on commercial property transactions from 2% to 6%. While this may reduce the volume of commercial transactions in the next years, it remains to be seen whether it will also divert the developers' attention to the residential market, as these report that commercial real estate is more profitable. The introduction of a stamp duty refund scheme for commercial land purchased for the development of housing was further added to this policy. Finally, to alleviate the current shortage of available properties in the private rental market, a new, time-limited deduction for pre-letting expenses was introduced.

Macroprudential policy is gaining importance amid the current housing sector dynamics. Current pressure in the housing market resulting from a scarcity of residential properties is emphasising the importance of prudent loan-to-value and loan-to-income limits. The 2017 review of mortgage-related measures saw the existing macroprudential framework essentially unchanged, apart from a minor modification restricting the banks' discretionary buffer above the 3.5 loan-to-income ratio to 10% for subsequent buyers. In addition, the CBI published a comprehensive Systemic Risk Pack that follows the medium-term macroprudential objectives across a series of indicators.

Conclusion

The government has taken measures to address public debt, non-performing loans and housing supply shortages. The government has used some proceeds, notably income from the sale of government's shares in state-owned banks, to accelerate reduction of the debt. Furthermore, in December 2017, Ireland repaid the outstanding IMF loans, together with the bilateral loans from Denmark and Sweden. Increasing public investment is addressing key infrastructure bottlenecks. The reduction of NPLs has continued, but at a slower pace, signalling persisted challenges in the long-term mortgage arrears category. The government has intervened repeatedly in the residential property market to support the recovery of supply buy it will take time for the measures to generate effects.

Table A1.1: **Overview Table of MIP-related reforms**

Increase the resilience of public finances			
Public debt reduction			
Announced measures	*Adopted measures*	*Implemented measures*	*Sources of commitment*
A debt-to-GDP target of 45% to be achieved by the end of the next decade. **July 2017**: An intermediary debt-to-GDP target of 55% until major capital projects are completed.		**2017**: Use of EUR 3.4 billion in receipts raised in disposing of Allied Irish Banks (AIB) shares to reduce public indebtedness. The National Asset Management Agency's (NAMA) disposal of its final amount of senior debt, thereby eliminating in full a contingent liability on the Irish sovereign. Early repayment of the outstanding IMF loans, together with the bilateral loans from Denmark and Sweden	CSR (1) – 2017" […] Use any windfall gains arising from the strong economic and financial conditions, including proceeds from asset sales, to accelerate the reduction of the general government debt ratio [...]"
Reduce vulnerability and broaden the tax base			
Announced measures	*Adopted measures*	*Implemented measures*	*Sources of commitment*
June 2016: A Rainy Day Fund once the Medium Term Objective (MTO) of a structural deficit of 0.5% of GDP is achieved; a consultation paper published.	**October 2017:** A reduced cap of 80% on the amount of capital allowances for intangible assets; Introduction of a new tax on sugar-sweetened drinks. Measures, which may **narrow** the tax base, such as increases to tax credits for self-employed and home carers, the creation of a stamp duty refund scheme for residential land, the reduction from seven to four years of the holding period to qualify for the capital gains tax exemption on certain property assets, the tapered extension of mortgage interest relief for the remaining recipients.		CSR (1) – 2017" […] limit the scope and the number of tax expenditures and broaden the tax base [...]"
Quality and effectiveness of public expenditure			
Announced measures	*Adopted measures*	*Implemented measures*	*Sources of commitment*

(Continued on the next page)

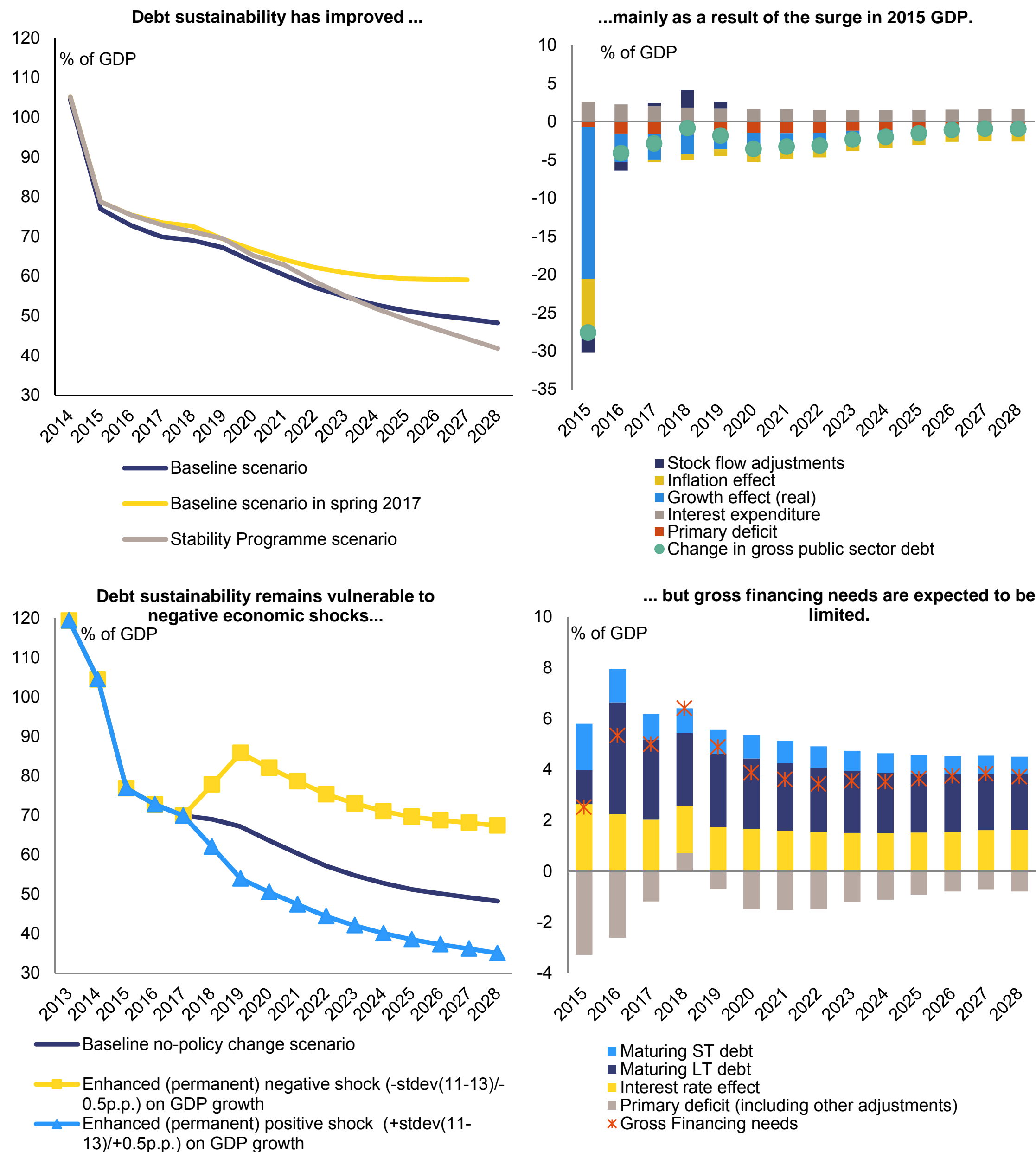
Table (continued)

October 2017: Increased capital expenditure by a further EUR 4.1 billion over the remaining period of the Capital Plan out to 2021. **August 2017:** The mid-term revision of the Capital Investment Plan prioritized areas such as housing, transport, water infrastructure but also education and healthcare, given the impact of population growth and ageing on these sectors.		Budget 2018 benefitted from a new spending review process which, in its first three-year cycle, has focused on specific critical spending areas, representing around 30% of current government expenditure, such as drug costs in the health sector, disability and employment programmes in the area of social protection, and public transport. While expenditure ceilings now include demographic pressures and carry-over effects of previously announced measures, at least in the most critical areas, it is still too early to assess whether the new spending review may also improve the reliability of the multiannual spending plan.	CSR (2) – 2017" […] Better target government expenditure, by prioritising public investment in transport, water services, and innovation in particular in support of SMEs. […]"
Reduce the stock of non-performing loans			
Announced measures	*Adopted measures*	*Implemented measures*	*Sources of commitment*
	Individual lenders have submitted their NPL reduction plans to the supervisor who is to assess their viability and degree of ambitiousness. Certain banks have been asked to revise their initial plans.	The number of personal insolvency applications has increased since the introduction of the *Abhaile* aid-and-advice scheme in 2016. However, recently there has also been an increase in creditors' rejections of the proposed insolvency arrangements, which transfers the cases to court procedure and results in a reduction of concluded arrangements. Hence, it is as of now unclear what the net effect on the use of personal insolvency arrangements will be.	MIP matrix and CSR (3) – 2017 "Encourage a more durable reduction in non-performing loans through resolution strategies that involve write-offs for viable businesses and households, with a special emphasis on resolving long-term arrears."
Monitor developments in the housing market			
Announced measures	*Adopted measures*	*Implemented measures*	*Sources of commitment*
May 2016: National Planning Framework, public consultation ended in November 2017. **July 2016**: Department of Housing, Planning and Local Government allocated an extra EUR 2.2 billion in support of the Action Plan on Housing and Homelessness out to 2021. Additional EUR 500 million allocated in the 2018 Budget. **April 2017:** 2 000 hectares of land in State/Semi-State ownership to be made available for residential development. **October 2017**: Up to EUR 750 million of the Ireland Strategic Investment Fund is	**March 2017**: Approval for 34 public infrastructure projects across 15 Local Authority areas as part of the Local Infrastructure Housing Activation Fund (with final go-ahead for 18 of them so far). **October 2017**: Changes to the capital gains tax. Increase in the vacant site levy. Increase in the level of stamp duty on commercial property transactions from 2 % to 6 % (in principle, with effect from 11 October 2017, but legislation pending). Stamp duty refund scheme for commercial land purchased for the development of housing. Time-limited deduction for pre-letting expenses.	Since **March 2017**: Nationwide roll out of Homeless Assistance Payment Scheme (Budget 2018 anticipated increasing the scheme by EUR 149 million in 2018)	MIP matrix and CSR (2) – 2017" […] Enhance social infrastructure, including social housing [...]"

Source: European Commission

ANNEX 2
Debt sustainability analysis

Graph A2.1: **Debt sustainability analysis**



(1) Baseline scenario: assumes forecasts for the forecast years, no policy change afterwards, with a structural primary balance kept constant at last forecast year (cyclical effects until closure of output gap estimated using standard budgetary semi- elasticity). Costs of ageing are included.
(2) The Stability Programme scenario: built under Stability Programme assumptions for main macro-fiscal variables and unchanged fiscal policy after programme horizon. An assumption of broadly stable expenditure in level terms contrasts with both pre-crisis trends and the government's own estimates presented in the last Budget.
(3) Enhanced sensitivity tests on real GDP growth: assumes -1 standard deviation/+1 standard deviation on real GDP growth for first 2 projection years, followed by -0.5/+0.5 p.p. over remaining of projection period).The shock is symmetrically applied to actual and potential GDP growth, so that the output gap remains unchanged. The cyclical component of the balance is therefore not affected by these shocks to growth.
(4) Details of the gross financing needs projections can be found in European Commission (2018), 'Debt Sustainability Monitor 2017' Directorate-General for Economic and Financial Affairs, European Economy, Institutional Paper 071/2018.
Source: European Commission

Ireland's debt sustainability has improved. Several factors bode well for debt sustainability. Recognising the improved fundamentals, Ireland is currently associated with creditor confidence. ([51]) Strong growth rates and a decrease in the headline deficit are expected to facilitate a steady pace of debt reduction. Net debt, as well as contingent liabilities to the financial sector are receding (see Annex 1). However, comparison with other countries is very much affected by the level shift in nominal GDP in 2015, which carries over into later years. The Commission analysis ([52]) based on the 2017 autumn forecast suggests that in a baseline no-policy-change scenario Ireland's public debt is projected to decrease by about 20.7% of GDP between 2017 and 2027, reaching 49.2% of GDP, below the Treaty reference value of 60% of GDP and the 55% of GDP intermediary public debt target of the government. This represents a considerable improvement compared to the previous debt sustainability analysis, where the debt decreased just below the Treaty reference value of 60% of GDP, to 59.1%, in the same period. Among other, this is due to higher economic growth and more favourable fiscal projections compared to the previous forecast round, which carries over into later years. The full implementation of the Stability Programme would put debt on a more firmly decreasing path, reaching 41.8% of GDP in 2027, more comfortably below the 60% of GDP reference value ([53]).

Yet, public finances remain vulnerable to shocks amid heightened uncertainty. According to the Commission's debt sustainability analysis, adverse shocks to real GDP growth — of a magnitude reflecting the country's historical variability of output ([54]) — would increase the public debt-to-GDP ratio by 18.9 pps. by 2027 compared to the baseline scenario, to about 68.1%. An adverse shock on the primary balance would lead to a debt ratio of 54.6% of GDP in 2027 ([55]). On the other hand, save for any potential future changes to market conditions, interest rate risk for the Irish sovereign remains low due to Ireland's public debt structure and its long debt maturity profile (see section 4) ([56]). Gross financing needs are expected to be limited.

([51]) Since the seventh PPS report, Moody's upgraded Ireland's sovereign credit rating in September 2017 from A3 to A2. This was followed by a similar move by Fitch in December 2017, upgrading the rating from A to A+.

([52]) The Commission's debt sustainability analysis makes use of both deterministic and stochastic projections over a 10-year period. Alternative scenarios are designed to capture possible future alternative 'states of the world'. The aim is to have a comprehensive set of debt projection results supporting conclusions in a context of future uncertainties. Scenarios are designed to be used in an integrated way to assess debt sustainability. See European Commission (2018), 'Debt Sustainability Monitor 2017' Directorate-General for Economic and Financial Affairs, *European Economy,* Institutional Paper 071/2018.

([53]) The Stability Programme scenario is built under Stability Programme assumptions for main macro-fiscal variables and unchanged fiscal policy after programme horizon. An assumption of broadly stable expenditure in level terms contrasts with both pre-crisis trends and the government's own estimates presented in the last Budget.

([54]) The negative enhanced sensitivity test on real GDP is designed based on a one standard deviation reduction in real GDP growth for first two projection years. Afterwards, -0.5/+0.5 pp. permanent shocks on GDP growth would be applied until the end of the projection period.

([55]) The sensitivity test on structural primary balance is designed based on negative shock to structural primary balance equal to 50% of forecasted cumulative change for first two forecast years. Afterwards, primary balance is kept constant at lower last forecast year level over remainder of projection period.

([56]) In turn, a permanent 1 pp. increase to short- and long-term interest rates on newly issued and rolled-over debt would raise the public debt-to-GDP ratio by 2 pps. by 2027 compared to the baseline scenario, to 51.2%.

ANNEX 3
Supplementary tables

Table A3.1: **Fiscal accounts (based on 2017 autumn forecast**

	2013	2014	2015	2016	2017	2018	2019
			% of GDP				
Indirect taxes	10.7	10.9	8.6	8.5	8.5	8.6	8.6
Direct taxes	12.7	12.8	10.6	10.6	10.6	10.6	10.8
Social contributions	5.8	5.6	4.3	4.4	4.4	4.4	4.3
Sales	2.7	2.4	2.0	1.7	1.6	1.5	1.5
Other current revenue	1.9	1.7	1.1	0.7	0.7	0.5	0.4
Total current revenue	**33.8**	**33.5**	**26.7**	**25.9**	**25.7**	**25.6**	**25.5**
Capital transfers received	0.2	0.2	0.1	0.3	0.1	0.1	0.1
Total revenue	**34.0**	**33.7**	**26.8**	**26.2**	**25.9**	**25.7**	**25.6**
Compensation of employees	10.3	9.4	7.2	7.0	7.1	7.0	6.9
Intermediate consumption	4.5	4.6	3.5	3.4	3.4	3.5	3.5
Social transfers in kind via market producers	2.8	2.6	2.1	2.1	2.0	1.9	1.9
Social transfers other than in kind	13.1	11.8	8.8	8.2	8.0	7.7	7.5
Interest paid	4.3	3.9	2.6	2.2	2.0	1.8	1.7
Subsidies	1.1	1.0	0.7	0.6	0.6	0.6	0.5
Other current expenditure	1.6	1.4	1.0	1.1	1.1	1.1	1.1
Total current expenditure	**37.7**	**34.7**	**25.8**	**24.7**	**24.1**	**23.6**	**23.1**
Gross fixed capital formation	2.0	2.1	1.7	1.8	1.9	2.0	2.4
Other capital expenditure	0.6	0.7	1.4	0.6	0.4	0.4	0.4
Total expenditure	**40.2**	**37.5**	**28.8**	**27.1**	**26.4**	**26.0**	**25.9**
General government balance	**-6.1**	**-3.6**	**-1.9**	**-0.7**	**-0.4**	**-0.2**	**-0.2**
Underlying government balance (EDP)	**-6.1**	**-3.6**	**-1.1**	**-0.8**	**-0.4**	**-0.2**	**-0.2**
			EUR billion				
Indirect taxes	19.3	21.2	22.5	23.4	24.6	26.1	27.2
Direct taxes	22.9	24.9	27.9	29.1	30.8	32.4	34.2
Social contributions	10.4	11.0	11.4	12.0	12.7	13.3	13.7
Sales	4.9	4.7	5.1	4.7	4.6	4.7	4.7
Other current revenue	3.4	3.3	3.0	2.1	1.9	1.6	1.2
Total current revenue	**60.9**	**65.2**	**69.9**	**71.3**	**74.7**	**78.0**	**81.0**
Capital transfers received	0.3	0.6	0.3	0.3	0.4	0.3	0.9
Total revenue	**61.5**	**65.9**	**70.6**	**72.6**	**75.4**	**78.8**	**81.8**
Compensation of employees	18.6	18.3	18.9	19.4	20.5	21.3	22.1
Intermediate consumption	8.2	8.9	9.2	9.4	9.8	10.7	11.0
Social transfers in kind via market producers	7.7	6.8	6.5	6.2	6.3	6.2	6.2
Social transfers other than in kind	23.5	23.0	23.0	22.7	23.1	23.3	23.8
Interest paid	7.8	7.6	6.9	6.2	5.9	5.6	5.5
Subsidies	1.9	1.9	1.8	1.7	1.7	1.7	1.7
Other current expenditure	2.9	2.8	2.6	3.0	3.3	3.3	3.6
Total current expenditure	**70.6**	**69.3**	**68.8**	**68.6**	**70.6**	**72.2**	**73.9**
Gross fixed capital formation	3.5	4.2	4.3	4.9	5.4	6.2	7.5
Other capital expenditure	1.1	1.3	3.5	1.5	1.1	1.3	1.3
Total expenditure	**73.6**	**71.8**	**73.1**	**75.6**	**74.6**	**76.6**	**78.8**
General government balance	**-11.0**	**-7.1**	**-5.0**	**-1.9**	**-1.2**	**-0.6**	**-0.6**
Deficit-increasing financial sector measures	0.00	0.02	2.10	-0.50	0.00	0.00	0.00
Underlying government balance (EDP)	**-11.0**	**-6.9**	**-2.9**	**-2.3**	**-1.2**	**-0.6**	**-0.6**

Source: European Commission

Table A3.2: **General Government debt projections (based on 2017 autumn forecast)**

	2011	2012	2013	2014	2015	2016	2017	2018	2019
Government deficit (% of GDP)	**-12.6**	**8.0**	**6.1**	**3.6**	**1.9**	**0.7**	**-9.7**	**-9.9**	**-9.9**
Government gross debt (% of GDP)	109.6	119.6	119.4	104.5	76.9	72.8	59.9	49.4	38.4
levels, EUR billion									
Government deficit	**-21.9**	**14.1**	**11.0**	**7.1**	**5.0**	**1.9**	**1.2**	**0.6**	**0.6**
Gross debt	189.7	210.0	215.3	203.3	201.6	200.6	173.7	150.7	122.1
Change in gross debt	45.5	20.3	5.3	-12.0	-1.9	-0.8	-26.9	-23.0	-28.6
Nominal GDP	173.1	175.6	180.3	194.5	262.0	275.6	290.2	304.9	318.3
Real GDP	167.1	172.6	175.5	190.1	238.7	250.9	263.1	273.3	281.8
Real GDP growth (% change)	**3.0**	**0.0**	**1.6**	**8.3**	**25.6**	**5.1**	**4.8**	**3.9**	**3.1**
Change in gross debt (% of GDP)	24.3	9.3	-0.2	-14.9	-27.6	-4.1	-12.9	-10.4	-11.1
Stock-flow adjustments (% of GDP)	13.6	3.5	-3.2	-9.8	-2.6	-1.1	0.4	2.3	0.9
% of GDP									
Gross debt ratio	**109.6**	**119.6**	**119.4**	**104.5**	**76.9**	**72.8**	**59.9**	**49.4**	**38.4**
Change in gross debt ratio	23.3	10.0	-0.2	-14.9	-27.6	-4.1	-12.9	-10.4	-11.1
Contribution to change in gross debt									
Primary balance	-9.3	-6.8	-3.2	0.5	1.9	4.3	33.9	35.8	37.0
"Snow-ball" effect*	0.4	1.9	1.2	-4.8	-24.3	-1.5	-1.6	-1.5	-1.2
of which									
Interest expenditure	*3.3*	*4.2*	*4.3*	*3.9*	*2.6*	*2.2*	*2.0*	*1.8*	*1.7*
Real growth effect	*0.0*	*0.0*	*-1.9*	*-9.2*	*-19.8*	*-3.8*	*-3.3*	*-2.6*	*-2.0*
Inflation effect	*-3.0*	*-2.2*	*-1.2*	*0.5*	*-7.1*	*0.0*	*-0.3*	*-0.8*	*-0.9*
Stock-flow adjustments	**13.6**	**3.5**	**-3.2**	**-9.8**	**-2.6**	**-1.1**	**0.4**	**2.3**	**0.9**
Implicit interest rate	*4.0*	*3.8*	*3.7*	*3.5*	*3.4*	*3.1*	*2.9*	*3.2*	*3.7*

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

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