Memorandum of Economic and Financial Policies

1. We have concluded that Ireland expeditiously requires a strong programme to restore domestic and external confidence and, thus, snap the pernicious feedback loops between the growth, fiscal, and financial crises.

2. We propose that such a programme comprise of four key elements:

- A fundamental downsizing and reorganisation of the banking sector—complemented by the availability of capital to underpin solvency—is required to restore confidence. Addressing market perceptions of weak bank capitalisation, overhauling the banks' funding structure, and immediately beginning a process of downsizing the banking system will be required.
- An ambitious fiscal consolidation building, on the progress already made.
- Renewing growth through a multi-pronged effort.
- A substantial external financial assistance will support the achievement of our policy objectives.

Recent Economic Developments and Outlook

3. After two years of sharp declines in output, the Irish economy is expected to broadly stabilise this year before expanding during 2011–14. As domestic imbalances from the boom years are being repaired, the recovery will, at least initially, be primarily export-driven. We project that GDP growth will increase over time as export performance filters through to investment and consumption, consumer confidence returns, and labour market conditions improve. We recognise that the risks in the short term are tilted to the downside, and, in particular, the headwinds from fiscal consolidation on domestic demand could be larger than anticipated. Over the longer haul also, continued private and public sector balance sheet adjustments, coupled with a weak banking sector, could delay the recovery.

4. Inflation is expected to remain low, reflecting the large output gap and modest external price pressures. Although the inflation rate will likely increase over time, it is expected to remain lower than in trading partner countries. This will have the benefit of improving competitiveness but the low rates of inflation would unavoidably keep real debt burdens high and dampen domestic demand.

5. The current account balance is projected to continue to improve gradually over the medium term, reflecting export expansion and the contraction in domestic demand. However, profit repatriation from multinationals and large interest payments to foreign holders of Irish debt are expected to limit the improvement over the programme period.

Restoring Financial Sector Viability

6. With its large size relative to the economy, its heavy reliance on wholesale funding, and its large exposures to the real estate sector, much of the domestic Irish banking system is in a stressed state. The Government has intervened heavily to safeguard financial stability. In late 2009, we established the National Asset Management Agency (NAMA) to take over certain vulnerable commercial and property development assets of banks. In addition, major efforts have been made to boost banks' capital.

7. Although the Government has made strong efforts to contain the fallout from the sector's vulnerabilities, a continued lack of market access and the loss of deposits have created significant funding pressures, alleviated largely by an increase in recourse to Eurosystem financing facilities and Emergency Liquidity Assistance by the Central Bank. Moreover, capital injections in the banks have placed a heavy burden on public finances.

8. Our proposed programme will take decisive steps to ensure the viability and health of the financial system. We intend to lay the foundations of this process very quickly, if we are to reassure the markets that banks will return to viability and will have the ability to operate without further state support in a reasonable period of time.

9. The key component of our efforts is an overhaul of the financial sector with the objective of substantial downsizing, isolating the non-viable parts of the system and returning the sector to healthy functionality. It will be important to support this process through capital injections into viable financial institutions. In addition, structural measures—a special resolution scheme for deposit-taking institutions and a further strengthening of the supervisory system—will impart greater stability to the system. It is our goal that the leaner and more robust system that emerges from these efforts will not be dependent on state support, will have a more stable funding base, and will provide the credit required to foster growth.

10. The plan to overhaul the banking system has several elements. First, banks will be required to run down non-core assets. Second, land and development property loans that have not yet been transferred to NAMA will also be transferred. Third, banks will be required to promptly and fully provide for all non-performing assets as needed. Fourth, the banks will be required to securitise and/or sell asset portfolios or divisions with credit enhancement, if needed, once the market normalises. And finally, swift and decisive action will be taken to resolve the position of Anglo Irish Bank (Anglo) and Irish Nationwide Building Society (INBS) in a way that protects depositors and strengthens the banking system. To this end, by end-January 2011, we will submit to the European Commission a revised proposal developed in collaboration with IMF to resolve Anglo and INBS. Each of these initiatives will require technical or legislative measures, most of which we believe can be expeditiously instituted.

11. To achieve the above goals, banks will be required to submit deleveraging plans to the national authorities by end-February 2011. The plans will be prepared on the basis of clear periodic targets defined by the Central Bank, taking into consideration the Prudential Liquidity Assessment Review (PLAR) to be conducted in consultation with the EC, ECB and IMF. By end-March 2011, the Central Bank with assistance from an internationally recognised consulting firm, will complete the assessment of the banks' restructuring plans (structural benchmark). The deleveraging plans will be a component of the restructuring plans to be submitted to the European Commission for approval under EU competition rules.

12. This reorganisation and downsizing of the banks will be bolstered by raising capital standards. While we expect that, in a restructured system, banks will be able to raise capital in the market, we recognise that the higher standards may imply that, in the short run, public provision of capital will be needed for banks that are deemed to be viable. To support this process—and to render it credible—we will undertake a review of the capital needs of banks on the basis of a diagnostic of current asset valuations and stringent stress tests (PCAR 2011).

- As an immediate step, to enhance confidence in the solvency of the banking system, the Central Bank will direct Allied Irish Bank (AIB), Bank of Ireland (BoI) and EBS to achieve a capital ratio of 12 percent core tier 1 by end-February 2011 (structural benchmark) and Irish Life & Permanent (ILP) by end-May 2011 (structural benchmark). This would imply an injection of fresh equity capital of €7bn into these four banks and provide an additional buffer for a potential increase in expected losses. This action, along with early measures to support deleveraging and taking account of haircuts on the additional loans to be transferred to NAMA (see ¶10) would result in an injection of €10bn of fresh capital into the banking system, above and beyond the already committed capital injection of €6.6bn for AIB previously announced by the Irish authorities.

- By end-December 2010, in consultation with EC, ECB, and IMF staff, we will define the criteria to run stringent stress test scenarios (structural benchmark). We will also agree with EC, ECB, and IMF staff, by end-December 2010, on draft terms of reference for the due diligence of bank assets by internationally recognised consulting firms (structural benchmark). We intend to complete the diagnostic evaluation of banks' assets by end-March 2011 and the stress tests (PCAR 2011) by end-March 2011 (both structural benchmarks), and transparently communicate our findings.

- Based on these assessments, starting end-April 2011, banks will be required to maintain a core tier 1 capital ratio of 10.5 percent. Banks will report their capital adequacy ratios to the Central Bank on a quarterly basis. The Central Bank's assessment of banks' capital adequacy ratio will be made public at least semi-annually.

13. The question of whether burden should be imposed on bank sub debt is influenced by two factors: the quantum of capital the State has committed to support the institution and the perceived viability of the bank in the absence of receiving such capital. Forced burden sharing through legislation is possible and legislation is currently being prepared in this regard. Alternatively, in certain cases, a very deeply discounted liquidity management exercise might also be an appropriate option.

14. In addition, we will finalise proposals to strengthen the legal framework for dealing with distressed deposit-taking institutions in line with recent EU developments (including EU competition rules) and international sound practices. Such a special resolution regime will broaden the available resolution tools with the aim of promoting financial stability and protecting depositors. In particular, the draft legislation will (i) provide for the appointment of a special manager where, in the opinion of the Central Bank, an institution's financial condition has severely deteriorated; (ii) grant powers to the Central Bank for the transfer of assets and liabilities to other institutions; and (iii) create a framework for the establishment of bridge banks. We seek to submit draft legislation including the above mentioned elements to Dáil Éireann by end-February 2011 (structural benchmark).

15. Moreover, we will continue the efforts to strengthen banking supervision by ensuring higher staffing levels and budget allocations in line with OECD best practices. We will enhance the risk assessment framework and raise the corporate governance standards. By end-September 2011, a report by an independent assessor on our compliance with Basel core principles for effective banking supervision will be made public.

16. We will also reform the personal insolvency regime for financially responsible individuals (including sole traders), which will balance the interests of both creditors and debtors. The objectives will be to lower the cost and increase the speed and efficiency of proceedings, while at the same time mitigating moral hazard and maintaining credit discipline. The new legal framework will include a non-judicial debt settlement and enforcement mechanism as an alternative to court-supervised proceedings.

17. We will continue to provide means-tested financial assistance to limit the economic and social fallout of the crisis. The existing mortgage interest supplement scheme is crucial for providing temporary assistance to distressed mortgage holders. The scheme's administration will be centralised to ensure a more consistent application focusing on households that are most in need, and further modification will be introduced in the 2011 Social Welfare Act.

18. Our strategy for the credit union sector is based on three components. First, we will complete a full assessment of their loan portfolios by end-April 2011 (structural benchmark). Second, by end-April 2011, we will have ready a comprehensive strategy to enhance the viability of the sector. And third, by end-December 2011 we will submit legislation to

Dáil Éireann to assist the credit unions with a strengthened regulatory framework including effective governance and stabilisation requirements.

19. We will continue efforts to ensure the flow of credit to viable businesses, building on actions already taken under previous recapitalisations and NAMA legislation. Allied Irish Bank and Bank of Ireland have agreed, in connection with recapitalisation last March, to make available not less than €3 billion each for targeted lending for new or increased credit facilities to small and medium-sized enterprises in both 2010 and 2011 as well as funds for seed and venture capital and for Environmental lending. The lending policies and decisions of both banks are subject to review by the Credit Review Office, which enables businesses who have had credit refused or withdrawn, to apply for an independent review of the bank's decision.

20. NAMA is subject to an extensive range of statutory Governance and Accountability arrangements and these will be fully adhered to. Members of the NAMA Board must have relevant experience and expertise, and the work of the Board is supported by audit and other sub-committees. NAMA operations are also subject to statutory codes of practice. NAMA is required to prepare various reports, including quarterly reports of its activities, and these are subject to scrutiny by Oireachtas committees. The Comptroller and Auditor General audit the annual accounts and prepare reports on NAMA for review by the Public Accounts committee.

Safeguarding Public Finances

21. To continue with the programme of fiscal consolidation, a comprehensive National Recovery Plan 2011-14 was approved by the Government and published on 24 November 2010. This Plan forms the basis for the 2011 budget consistent with fiscal consolidation measures amounting to €15 billion, a 9 percent of GDP budgetary correction over the period 2011–14. Having stabilised the deficit, albeit at a high level, the steps announced in the Plan will place the budget deficit-to-GDP ratio on a firm downward path. While the debt-to-GDP ratio will remain at high levels for the next few years, it is projected to decline thereafter, underpinning debt sustainability. We also propose to keep under review progress towards meeting the Stability and Growth Pact targets.

22. Budget 2011 which will include adjustment measures of €6 billion, will be submitted to Dáil Éireann for passage on 7 December (prior action). As set out in the National Recovery Plan, most of this adjustment will come from the expenditure side. The capital budget will be reduced, partly through greater value for money in our infrastructure procurements. On current expenditures, we are pursuing public service numbers reductions through natural attrition and voluntary schemes, adjustments in public service pensions, and further savings on social transfers (from reductions in working age payments, reductions in universal child benefit payments and other reforms). Protecting the socially vulnerable at a

time of difficult economic adjustment remains a central policy goal. Current savings will also be realised from streamlining government programmes and through administrative efficiencies. Should these savings or the expected numbers reductions not materialise, we reserve the option to take further measures.

23. An income tax-led revenue package—sized at over €2 billion in a full year—will supplement the above expenditure measures in 2011. Over the past decade, the proportion of citizens exempt from income tax has risen to 45 percent and tax credits have doubled, resulting in a comparatively low burden of tax on ordinary incomes. This is no longer sustainable. Accordingly, we are widening the tax base, by lowering income tax bands and credits by 10 percent, and by reducing various pension-related tax reliefs. We are also taking action on other tax expenditures, and distortions arising from the existence of multiple levies.

24. To secure our fiscal targets, a number of fiscal measures have been identified for 2012–14. We will continue to rely on expenditure savings (€6.1 billion), led by current spending (€4.9 billion), as outlined in the National Recovery Plan. We are targeting further reductions in public sector numbers, social benefits and programme spending, and have anchored the prospective savings by publishing multi-year expenditure ceilings by Vote Group through 2014. We are also planning to move towards full cost-recovery in the provision of water services and ensuring a greater student contribution towards tertiary education, while ensuring that lower-income groups remain supported. In addition, we will accelerate the process of placing the pension systems on a path consistent with long-term sustainability of public finances. On the tax side, we will build on the base-broadening measures outlined above and establish a sound basis for sub-national finances through a new residential-property based site value tax. The Finance Bill 2012 will contain necessary provisions to bring into effect the already signalled VAT increases in 2013 and 2014.

25. We are preparing institutional reform of the budget system taking into account anticipated reforms of economic governance at the EU level. A reformed Budget Formation Process will be put in place. Furthermore, we will introduce a Fiscal Responsibility Law which will include provision for a medium-term expenditure framework with binding multi-annual ceilings on expenditure in each area by end-July 2011 (structural benchmark). A Budget Advisory Council, to provide an independent assessment of the Government's budgetary position and forecasts will also be introduced by end-June 2011 (structural benchmark). These important reforms will enhance fiscal credibility and anchor long-term debt sustainability.

Raising the Growth Potential

26. We recognise the need to restore strong sustainable growth. The structural changes to the financial and fiscal sectors, described above, are critical for improving the prospects of economic recovery and raise the medium-term growth potential. Although, as is widely recognised, Ireland is a global leader in providing a business-friendly environment, the

National Recovery Plan includes a strategy to remove remaining structural impediments to competitiveness and employment creation. It also details appropriate sectoral policies to encourage exports and a recovery of domestic demand, which will also support growth and promote jobs.

27. Specifically, we will continue to press ahead with other structural reform as set out in the Memorandum of Understanding on specific economic policy conditionality:

- We will promote service sector growth through vigorous action to remove remaining restrictions on trade and competition, and will propose amendments to legislation to enable the imposition of financial and other sanctions in civil law cases relating to competition.

- Building on the forthcoming report of the Review Group on State Assets & Liabilities the government will undertake an independent assessment of the electricity and gas sectors with a view to enhancing their efficiency. State authorities will consult with the Commission Services on the results of this assessment with a view to setting appropriate targets for the possible privatisation of state-owned assets.

- To reduce long-term unemployment and to facilitate re-adjustment in the labour market, we will reform the benefits system and legislate to reform the national minimum wage. Specifically, changes will be introduced to create greater incentives to take up employment.

Programme Financing

28. Ireland is facing large and medium-term balance of payments needs that arise from (i) substantial pressures on the capital account that need to be relieved, and (ii) the need to build up reserves to improve banks' ability to meet their large external debt rollover needs. The programme's success is dependent on substantive external financial assistance. This external financing will serve as a bridge during the implementation of the critical reforms to fundamentally restructure the banking system and restore fiscal sustainability. It is our view that, given Ireland's medium-term structural adjustment needs, an arrangement under the Extended Fund Facility (EFF) would be appropriate. Such an arrangement would also have the added benefit of a more realistic repayment schedule for Ireland.

29. Notwithstanding the large fiscal adjustment, we estimate the financing need to be up to €85 billion until the end of 2013. This includes a contingency element for bank recapitalisation. An amount of €17.5 billion will be covered by an Irish contribution through the Treasury cash buffer and investments of the National Pension Reserve Fund. We expect commitments from the IMF under the Extended Arrangement to amount to €22.5 billion and EU financial support from the European Financial Stability Mechanism/European Financial Stability Facility and bilateral arrangements to amount to €45 billion. Ireland will draw on

these resources in parallel throughout the programme period. While the envelope of resources to be provided to Ireland is a source of reassurance to the authorities and to financial markets, we plan to draw pari passu on IMF and EU financial support on an as needed basis. Moreover, if market access is restored on a sustainable basis, we would anticipate paying down the drawings made on an advanced schedule.

30. We are confident that the implementation of the fiscal and banking sector reforms will help the economy recover.

Programme Monitoring

31. Progress in the implementation of the policies under the programme will be monitored through quarterly and continuous performance criteria, indicative targets, structural benchmarks, and quarterly programme reviews and compliance with requirements under the Excessive Deficit Procedure (EDP). The attached Technical Memorandum of Understanding (TMU) defines the quantitative performance criteria and indicative targets under the programme. The Government's targets for the exchequer balance (central government cash balance) excluding interest payments will be monitored through quarterly performance criteria and net central government debt will be an indicative target (Table 1). As is standard in IMF arrangements, there will be a continuous performance criterion on the non-accumulation of external payment arrears. Progress on implementing structural reforms will be monitored through structural benchmarks (Table 2). A joint EC-ECB Memorandum of Understanding specifies, notably, the structural policies recommended in the MEFP, and sets a precise time frame for their implementation.

32. As is standard in all Fund arrangements, a safeguards assessment of the Central Bank of Ireland will be completed by the first review of the arrangement. In this regard, the Central Bank will receive a safeguards mission from the Fund and provide the information required to complete the assessment by the first review. As a related matter, and given that financing from the IMF will be used to provide direct budget support, a framework agreement will be established between the government and the Central Bank of Ireland on their respective responsibilities for servicing financial obligations to the IMF. As part of these arrangements, Fund disbursements will be deposited into the government's account at the Central Bank.

33. We authorise the IMF and the European Commission to publish the Letter of Intent and its attachments, and the related staff report.

Table 1. Ireland: Quantitative Performance Criteria and Indicative Targets under the Economic Programme for 2010–11

	December 31, 2010	March 31, 2011	June 30, 2011	September 30, 2011	December 31, 201 1
	(In billions of Euros)				
	Performance Criterion	Performance Criterion	Indicative Target	Indicative Target	Indicative Target
1. Cumulative exchequer primary balance 1/	-15.3	-7.8	-11	-14.3	-14.6
2. Ceiling on the accumulation of new external payments arrears on external debt contracted or guaranteed by the central government 2/	0	0	0	0	0
	Indicative Target	Indicative Target	Indicative Target	Indicative Target	Indicative Target
3. Ceiling on the stock of central government net debt	83.1	91.6	96.5	100	102.2

1/ Measured by the exchequer balance excluding interest payments. Cumulative from the start of the relevant calendar year.
2/ Applies on a continuous basis.

Table 2. Prior Action and Structural Benchmarks Under the Economic Programme for 2010–11

Measure		
Submit the 2011 Budget to Dáil Éireann (MEFP, ¶22).	7 December 2010	Prior Action
Define the criteria to run stringent stress tests scenarios (MEFP ¶12).	End-December 2010	Structural Benchmark
Agree on terms of reference for the due diligence of bank assets by internationally recognised consulting firms (MEFP, ¶12).	End-December 2010	Structural Benchmark
The Central Bank will direct the recapitalisation of the principal banks (AIB, BoI and EBS) to achieve a capital ratio of 12 percent core tier 1 (MEFP, ¶12).	End-February 2011	Structural Benchmark
Submit to Dáil Éireann the draft legislation on a special resolution regime (MEFP, ¶14).	End-February 2011	Structural Benchmark
The Central Bank to complete the assessment of the banks' restructuring plans (MEFP, ¶11).	End-March 2011	Structural Benchmark
Complete the diagnostic evaluation of banks' assets (MEFP, ¶12).	End-March 2011	Structural Benchmark
Complete stress tests (PCAR 2011) (MEFP, ¶12).	End-March 2011	Structural Benchmark
Complete a full assessment of credit unions' loan portfolios (MEFP, ¶18).	End-April 2011	Structural Benchmark
The Central Bank will direct the recapitalisation of ILP to achieve a capital ratio of 12 percent core tier 1 (MEFP, ¶12).	End-May 2011	Structural Benchmark
Establish a Budget Advisory Council. (MEFP, ¶25).	End-June 2011	Structural Benchmark
Introduce a medium-term expenditure framework with binding multi-annual ceilings on expenditure in each area (MEFP, ¶25).	End-July 2011	Structural Benchmark