EUROPEAN ECONOMY

Occasional Papers 78 | May 2011

The Economic Adjustment Programme for Ireland Spring 2011 Review

Directorate-General for Economic and Financial Affairs

Economic and Financial Affairs
DIRECTORATE-GENERAL

EUROPEAN COMMISSION

Occasional Papers are written by the Staff of the Directorate-General for Economic and Financial Affairs, or by experts working in association with them. The “Papers” are intended to increase awareness of the technical work being done by the staff and cover a wide spectrum of subjects. Views expressed do not necessarily reflect the official views of the European Commission. Comments and enquiries should be addressed to:

European Commission
Directorate-General for Economic and Financial Affairs
Publications
B-1049 Brussels
Belgium
E-mail: mailto:Ecfin-Info@ec.europa.eu

This paper exists in English only and can be downloaded from the website
ec.europa.eu/economy_finance/publications

A great deal of additional information is available on the Internet. It can be accessed through the Europa server (ec.europa.eu)

KC-AH-11-078-EN-N
ISBN 978-92-79-19330-9
doi: 10.2765/16010

European Commission
Directorate-General for Economic and Financial Affairs

The Economic Adjustment Programme for Ireland

Spring 2011 Review

EUROPEAN ECONOMY Occasional Papers 78

ACKNOWLEDGEMENTS

The report was prepared in the Directorate General Economic and Financial Affairs under the direction of István P. Székely, Director and European Commission mission chief to Ireland.

Contributors:

Sean Berrigan (Director for financial stability), Álvaro Benzo, Shane Enright, Nikolay Gertchev, Gábor Koltay, Sven Langedijk, Peter Lohmus, Davide Lombardo, Jānis Malzubris, Ralph Setzer, John Sheehy, Jacek Szelożyński and the financial crisis task force of the Directorate General for Competition.

Comments on the report would be gratefully received and should be sent, by mail or e-mail to:

Sven Langedijk,

European Commission,

Unit ECFIN-H-2,

BU 1 00-188

B-1040 Brussels

e-mail: sven.langedijk@ec.europa.eu

CONTENTS

LIST OF TABLES

LIST OF GRAPHS

LIST OF BOXES

EXECUTIVE SUMMARY

A joint EC/IMF/ECB mission visited Dublin 5-15 April 2011 to conduct the first review of the economic adjustment programme. The mission also discussed policy challenges ahead and an updated specification of the program conditionality for future reviews. This report provides a detailed assessment of compliance and summarises the main findings of the mission.

The macroeconomic framework of the programme remains broadly unchanged. Delayed investment recovery, however, warrants a slight revision of the 2011 growth rate, to around ½%. The anticipated rebalancing is taking place, with exports remaining strong, supported by world trade and competitiveness improvements, while fiscal consolidation and private sector balance sheets adjustment continue to dampen domestic demand.

Programme implementation is on track, but challenges remain. Through its Programme for Government and its decisive approach to banking sector reforms, the new Government has taken strong ownership of the goals of the EU-IMF program.

- **Important progress was made in reforming the banking system**. The Prudential Capital and Liquidity Assessment Reviews (PCAR/PLAR), which were conducted by the Central Bank of Ireland (CBoI) in consultation with programme partners and with the assistance of independent external consultants, were well received by the market. Based on these reviews, banks will be recapitalized, reorganized and deleveraged, also making up for the initial recapitalisation of three domestic banks that had to be delayed because of the early general elections. All other financial sector conditionality was met.
- **The fiscal programme is on track.** The agreed fiscal measures have been implemented, and the 2010 fiscal target was met. Fiscal outturns in the first quarter of 2011 have also been in line with the programme. The general government 2011 overall deficit is forecast to remain below the programme ceiling, despite the downward revision in nominal GDP.
- **Steps have been taken towards the achievement of the structural reform objectives.** These include the launching of a thorough independent review of the sectoral wage setting arrangements and a reform of unemployment benefit system to reduce replacement rates and increase the effectiveness of activation measures.

Resolute fiscal consolidation and implementation of the structural reform plans are essential to dispel doubts about debt sustainability and mitigate remaining risks. Commission analysis continues to indicate that Ireland's debt is sustainable, even under adverse scenarios, as long as the programme is fully implemented. The new government is fully committed to the programme's fiscal targets and overall objectives. The planned reforms to strengthen the fiscal framework, including through a comprehensive review of expenditure, the establishment of an independent Fiscal Advisory Council, the introduction of prudent fiscal rules, and the adoption of medium-term expenditure ceilings should also contribute to enhance fiscal policy credibility. On 10 May, the Government announced a Jobs Initiative to address the high and increasingly long-term unemployment, and confirmed its commitment to keep it fully budget neutral through 2014 (a prior condition for the completion of the review).

The Commission Services support the completion of the review. Program implementation has been strong and the policy intentions spelled out in the Memorandum of Economic and Financial Policies, and detailed in the Memorandum of Understanding on Specific Economic Policy Conditionality, are fully in line with the goals of the program. The next disbursement to Ireland, EUR 3 billion, is expected to take place in the second quarter of 2011.

INTRODUCTION

Upon a request from the Irish government on 21 November 2010, understandings were reached toward a EUR 85 billion financial assistance programme between the Irish government, the IMF and the European Commission, in liaison with the ECB, in late November 2010. The programme was subsequently approved by the Council (2011/77/EU) on 7 December and by the IMF Board on 16 December 2010. In addition to the provision of funding to meet budgetary financing needs, the programme (Box 1) also provides for up to EUR 35 billion to cover the costs of recapitalising and deleveraging the domestic banks. Moreover, it contains a broad range of financial, fiscal, and structural measures.

Box 1: The economic adjustment programme for Ireland

Origin of the crisis

Ireland experienced strong growth from the early 1990s, after decades of poor economic performance. Boom-related windfall fiscal revenues were largely spent, contributing to overheating and loss of competitiveness. Amid intense competition for profits in the booming economy and property market, the pace of credit expansion accelerated sharply. Light-touch macro-prudential regulation and supervision did little to stem the swelling banking sector imbalances. From late 2007, investor confidence in Ireland's property sector evaporated amid concerns about oversupply and a price bubble. This left Ireland facing the twin problems of a sharp decline in cyclical construction-related revenues and the sudden appearance of very large losses in the domestic banking system. From 2008, policies to address budgetary and financial stability concerns included fiscal consolidation as well as a range of banking support measures such as guarantees, capital injections and regulatory reforms. However, by 2010 GDP had fallen from peak by an estimated 17% in nominal terms and the government deficit excluding one-off measures had increased to around 12% of GDP. Unemployment ratcheted upwards.

By the autumn of 2010 the loss of investor confidence in Ireland triggered a vicious cycle. Banks lost access to market funding and corporate deposit outflow accelerated, and the cost of government borrowing reached unsustainable highs. These challenges led the Irish authorities to request external help on 21 November 2010.

Programme objective and design

The EU-IMF financial assistance programme supports the authorities' efforts by providing a breathing space in terms of financing to get the adjustment on a firm footing and regain access to market funding at affordable interest rates. The objective is to restore Ireland's domestic banking system to health, restore growth, and put public finances on a sustainable path.

The banking sector will become smaller and focussed on Ireland's needs, and credit institutions will be recapitalised to cover for future losses. Frontloaded fiscal consolidation will put the debt-to-GDP ratio on a firm downward trajectory after peaking in 2013. Reform to the budgetary process will help to ensure adequate safeguarding of public finances. A sustainable economic growth path requires further relative price and wage adjustment and shifts of production capacity across sectors. Structural reform measures to boost competition and avoid unemployment traps are an important part of this strategy.

The Council Implementing Decision 2011/77/EU on granting EU financial assistance to Ireland envisages that the Commission prepares a quarterly review of progress on observance of quantitative performance criteria, respect for EU Council Decisions and, when and where applicable, Council Recommendations in the context of the excessive deficit procedure. The quarterly review also evaluates progress made with respect to policy criteria in the Memorandum of Economic and Financial Policies (MEFP), and the Memorandum of Understanding on Specific Economic Policy Conditionality (MoU), which specifies the detailed criteria that will be assessed for the successive reviews up to the end of 2013. Release of further instalments of financial assistance will be conditional on a positive assessment of progress in this regard.

In this context, this report assesses compliance with quantitative and policy conditionality associated with the first review of the EU Financial Assistance to Ireland. The report outlines financial and macro-fiscal developments since the programme was agreed, and compliance with the conditionality up to end-March 2011. It then describes proposed changes to the MEFP and MoU. This report provided the basis for the EFC and the Commission's assessment of progress towards the programme objectives and completion of the programme review. It also provided the background for a Commission proposal for a Council Implementing Decision amending Council Implementing Decision 2011/77/EU to update the policy conditionality against which Ireland's implementation of the conditions of EU financial assistance over the next quarterly reviews is to be assessed (this Implementing Decision has been adopted by the Council on 17 May 2011).

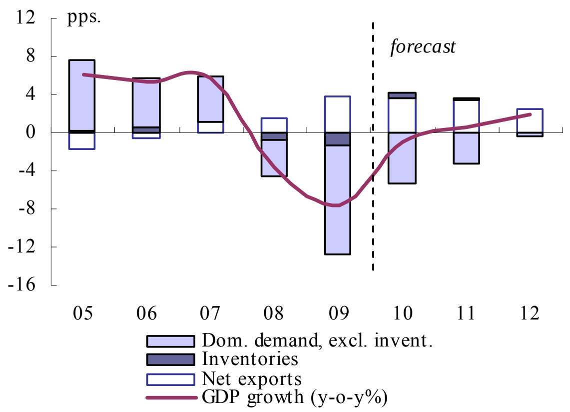
ECONOMIC DEVELOPMENTS AND OUTLOOK

MACROECONOMIC FRAMEWORK

Decline in GDP was higher in 2010 than previously projected. The negative surprise, a decline of 1% against an expected -0.2%, reflects mostly a larger-than-anticipated reduction in stocks and an unexpected deceleration in the latter part of 2010 in the contribution to growth from net trade, which is traditionally sizable but rather volatile. Nevertheless, rebalancing continued, with net exports contributing 3.5pp to GDP growth in 2010, on the back of a continued strong export performance (volumes grew by 9.4% in 2010). Domestic demand made a negative contribution of some 5.4pp to GDP growth, in line with programme assumptions, reflecting continued retrenchment in public (-2.2%) and private consumption (-1.2%), and a further sharp reduction of investment (-27.8%).

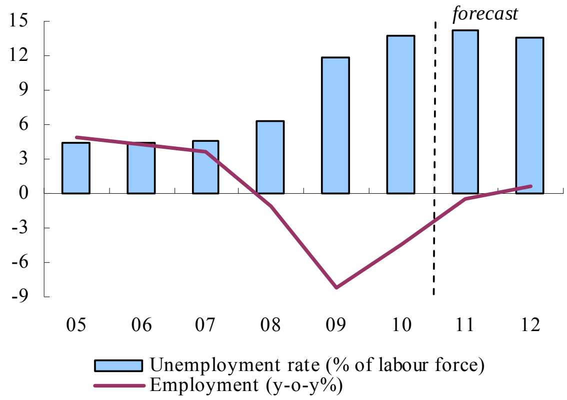
The unemployment rate also surprised on the upside in 2010, albeit mainly because of a slower-than-expected contraction of labour supply. Labour participation rate stabilized after several quarters of decline, while outward migration was less than anticipated. As a result, the unemployment rate reached 14.1% in Q4 2010 (13.6% on average in 2010). While this development may accentuate the challenges in the labour market and put more pressure on the budget, it also represents a possible source of upside risk in that, if net outward migration proves less than previously expected, Ireland's growth potential may also be higher than assumed. The higher base in 2010 does call, however, for an upward revision of average 2011 unemployment rate to 14.5%.

Graph 1: Contributions to growth



Source: Commission services

Graph 2: Employment and unemployment

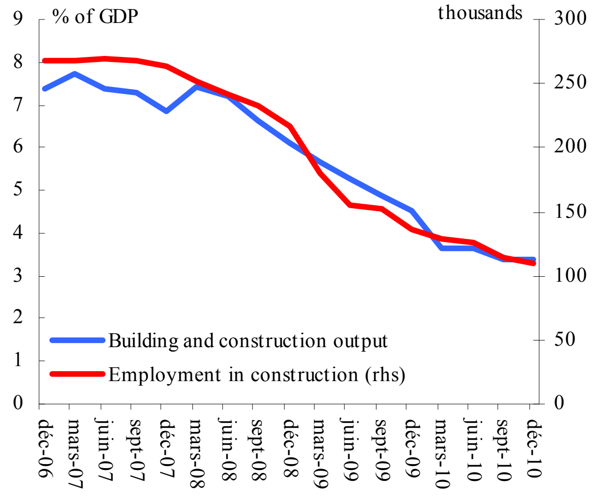


Source: Commission Services

Reflecting these developments, the forecast for real GDP growth in 2011 has been revised down from 0.9% to 0.6% (Table 1). Strong export growth is expected to continue (6.4%) this year on the basis of strong PMI data, relatively robust trading partner growth and the support of recent competitiveness gains. Reflecting the uptick in late 2010, import growth has been revised up somewhat, which will contain the contribution to GDP growth from net exports to just below 4 percentage points. In terms of domestic demand, the outlook for consumption remains subdued, reflecting compression of disposable income linked to increases in mortgage servicing costs, higher net taxes supporting the envisaged fiscal consolidation, and downward pressures on wages from the continued large slack in the labour market. Public consumption has been revised in view of information provided in the Revised Estimates published in February 2010. Investment is envisaged to decline further, by 13.5%, again reflecting a sharp contraction in construction (-24%), while other forms of gross fixed capital formation are envisaged to contribute positively to GDP, driven by the strong export performance. Growth forecasts for 2012 and outer years have been kept unchanged.

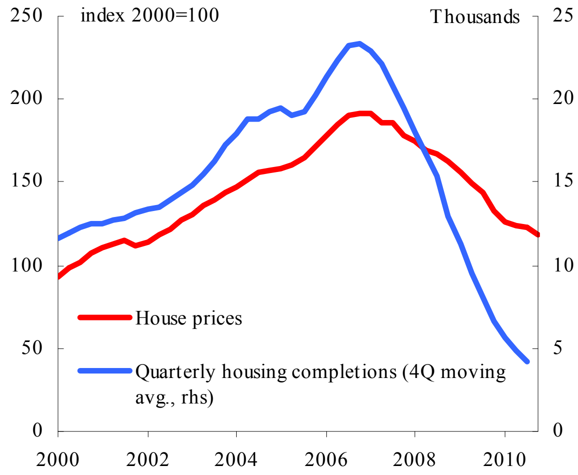
Risks around the central forecast are balanced. On the downside, the contraction in disposable income could prove more pronounced if hikes in policy interest rates and their impact on variable-rate mortgages turn out to be larger and come earlier than expected. Investment is now fairly compressed—see Box 2—and there would seem to be limited (if any) scope for downside risks from this channel. On the upside, export performance could exceed the baseline forecast, which may prove relatively conservative in light of Ireland's recent competitiveness gains (see also below).

Graph 3: Building and construction



Source: Eurostat

Graph 4: House prices and completions



Source: CSO

Box 2: Contribution to growth from investment in construction over the cycle

The share of building and construction in Irish GDP peaked at 7½% in 2006, with the completion of a remarkable 93,000 housing units in that year – about one new unit for every twenty households. Since then, confidence in the property sector has all but evaporated with strong evidence of oversupply. Completions of new housing plummeted to about 14,000 units in 2010, with the only support coming from a sustained level of public capital formation as commitment to pre-existing infrastructural projects continued. By the last quarter of 2010 employment in construction had fallen by about 60% from its peak, to 109,000.

The fall in building and construction as a share of GDP has by now been very large. While a further fall this year and next year are factored into forecasts, as new mortgage lending and housing commencements remain at record lows, the potential for a further drag on growth is now greatly reduced due to the much reduced weighting of residential construction in GDP (overall, just 2% of economic output this year and next).

For domestic banks, most of the losses on commercial property have been realized, as the bulk of these assets have been transferred to NAMA. Some risks from real estate exposure remain, as households struggle to service their mortgages (the stock of mortgage lending to households fell by 9.9% in the year to February, as households use their savings to retire debt). The remaining losses, also on the smaller commercial loans not transferred to NAMA, have however been adequately captured in the recent stress test.

Table 1 Macroeconomic framework

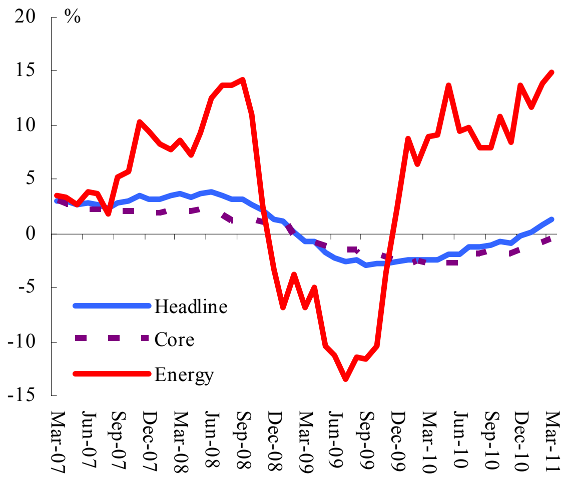
	April 2011 Forecast			December 2010 Forecast		
	2010	2011	2012	2010	2011	2012
	% change on previous year					
Real GDP growth	-1.0	0.6	1.9	-0.2	0.9	1.9
Private consumption	-1.2	-1.9	-1.0	-2.2	-1.9	-1.0
Public consumption	-2.0	-4.4	-0.4	-2.2	-5.7	-1.8
Fixed investment	-27.7	-13.5	2.0	-21.1	-8.9	1.8
Domestic demand (contribution)	-5.3	-3.3	-0.4	-4.4	-3.1	-0.6
Inventories (contribution)	0.6	0.2	0.1	0.7	0.3	0.1
Exports	9.3	6.0	5.2	5.7	4.5	4.5
Imports	6.5	3.2	4.0	2.3	0.9	2.7
Net trade (contribution)	3.6	3.8	2.2	3.4	3.7	2.5
Employment	-4.1	-1.5	0.4	-4.0	-0.8	0.5
Unemployment rate (level)	13.6	14.5	13.9	13.6	13.4	12.7
GDP deflator	-2.6	0.6	0.9	-1.8	0.4	0.6
HICP inflation	-1.6	1.0	0.7	-1.5	0.4	0.6
Current account (% of GDP)	-0.7	1.2	1.8	-0.9	1.2	2.2
Nominal GDP	153.9	155.9	160.3	156.4	158.5	162.7
	level as % of GDP					
General government						
General government balance	-32.4	-10.5	-8.8	-32.0	-10.6	-8.6
Primary government balance	-29.2	-6.8	-4.2	-29.0	-6.8	-4.1
Interest expenditure	-3.3	-3.8	-4.6	-3.0	-3.8	-4.6
General government debt	96.2	112.0	117.9	95.0	112.4	118.7

Source: Commission services

The inflation rate has turned positive in Ireland for the first time in two years, reaching 1.5% in April. This is reflective of external pressures and market-specific developments in the insurance sector, which are anticipated to push the average inflation rate for 2011 up to 1%. The core inflation rate, excluding unprocessed food and energy, however, was still negative (-0.6% in year to February), due to weak demand conditions in the non-traded sector.

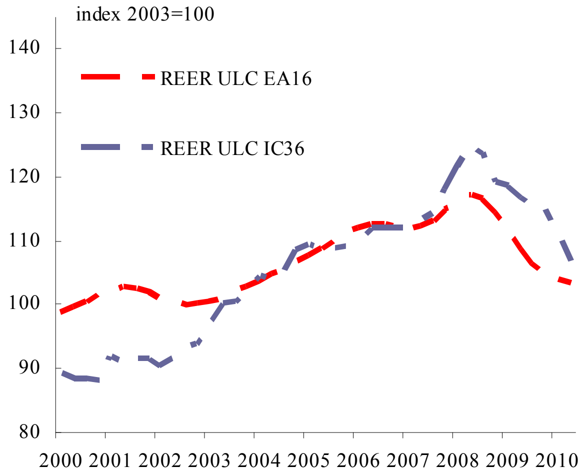
Wage moderation continues. Hourly wages declined in 2010 by 1.7%, although the public sector contributed the bulk of this decline. For this year, overall wages are expected to contract further, although at a slower pace, as public sector nominal wages will be kept unchanged and private sector wages decline further. This will support some further moderate gains in competitiveness (Graph 6).

Graph 5:Irish HICP Inflation



Source: Eurostat

Graph 6: ULC-based real exchange rate



Source: CSO

FISCAL PERFORMANCE

Fiscal performance so far has been in line with programme targets. In 2010, central government tax revenue was slightly better than expected (0.1 pp of GDP), partly offset by higher expenditure. This, together with a better-than-expected outturn of local government balance, improved the general government balance in nominal terms by some EUR 0.3 billion, as compared to the programme. However, downward revision of nominal GDP had a negative denominator effect on the deficit-to-GDP ratio of more than 0.5 pp, pushing the deficit-to-GDP ratio to 32.4% (versus 32.0% in the programme). Budget deficit (cash data) for January-March 2011 remains broadly in line with programme targets, with somewhat higher corporate income tax (CIT) and excise duty revenues offsetting some weakness in revenues from personal income tax (PIT) and value-added tax (VAT) (Graph 7). On the expenditure side, outlays are some 250 million below the government's target, but this is likely to reflect only timing issues (Graph 8).