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Results of in-depth reviews under Regulation (EU) No 1176/2011 on the prevention and correction of macroeconomic imbalances

Ireland: The recently completed macroeconomic adjustment programme was instrumental to manage economic risks and reduce imbalances. However, the remaining macroeconomic *imbalances require specific monitoring and decisive policy action*. In particular, financial sector developments, private and public sector indebtedness, and, linked to that, the high gross and net external liabilities and the situation of the labour market mean that risks are still present. The Commission will put in motion a specific monitoring of the policy implementation, and will regularly report to the Council and the Euro Group. This monitoring will rely on post-programme surveillance.

More specifically, starting in 2007, Ireland experienced a collapse of the property market, and measures to address losses in banks and a fall in government revenues gave rise to severe budgetary problems. On the back of a loss of market access, Ireland sought international financial assistance at the end of 2010. Ireland maintained a strong track record of implementation throughout the programme, which was completed in 2013. The fiscal consolidation targets under the programme have been met, and Ireland has improved domestic fiscal rules and institutions. Moreover, the headline deficit is projected to meet the targets in 2013 and 2014. Bank deleveraging targets have been met and capital adequacy ratios have improved. Financial supervision and regulation have been strengthened. Households have increased their saving rates to reduce their indebtedness. Labour market reforms contributed to a reduction in unemployment. House prices have also stabilized and shown signs of recovery. Nonetheless, more progress is needed as public debt remains very high, as does external debt, the financial sector is vulnerable with a high amount of non-performing loans and long-term and youth unemployment remains elevated.

Excerpt of country-specific findings on Ireland, COM(2014) 150 final, 5.3.2014

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EXECUTIVE SUMMARY AND CONCLUSIONS

Under the three-year EU-IMF financial assistance programme which ended in December 2013, Ireland implemented an impressive macroeconomic adjustment programme. The government launched a consolidation programme which reduced the general government deficit from 10.6 % of GDP in 2010 (excluding bank support measures) to 7.2% in 2013, and significantly improved fiscal rules and institutions. Banks embarked on an impressive deleveraging process with loan-to-deposit ratios falling from 210% in 2008 to 119% in 2013. Bank capital adequacy ratios rose on the back of stress tests followed by further government capital injections. The supervisory and regulatory role of the central bank was significantly strengthened through numerous reforms. The authorities undertook a series of labour market reforms, including a reshaping of activation policies. The unemployment fell steadily from a high of 14.9% in late 2011 to 12.1% at end-2013 as labour costs declined. Private households increased their saving rates significantly to reduce their indebtedness, while house prices, after falling by more than 50% compared to the 2007 peak, have recovered especially in Dublin. As a result, real GDP posted low but positive growth in 2011-13, on average higher than euro-area growth.

Nonetheless despite these achievements, imbalances remain important. In particular:

- **Private sector debt is about three times the level of aggregate economic activity, though it has started to decline recently.** The high level of private sector indebtedness is related in part to Ireland's significant multinational corporation sector that maintains high levels of foreign-funded investment. Smaller domestic firms' and household debt, in part a legacy of the housing boom, is also comparatively high but has declined from late 2008.

- **The government debt-to-GDP ratio is estimated to have peaked at 122% in 2013.** This high level of debt reflects, amongst other factors, sizeable government banking support measures and the impact the decline in the property market had on government revenues. Contingent liabilities, though declining, are also large. Still, the fact that government debt is largely long-term and at low interest rates improves its sustainability.

- **The financial sector remains vulnerable**. Non-performing loans are high at nearly 27% of total loans for the three main domestic banks as of mid-2013 and they continue to increase, albeit at a reduced pace. The profitability of banks is also challenged due to the structure of their assets, which is linked to the large amount of tracker mortgages (low-yielding legacy assets) they hold. In the medium term, Irish banks are also susceptible to a weakening of their capital positions after the Basel III accord on regulatory standards for bank capital adequacy, stress testing and market liquidity risk is implemented.

- **The external accounts show a large negative international investment position (NIIP), though this is essentially due to high government debt.** The latter is a direct result of the government bailout of the banks and the debt inflows under the EU/IMF financial assistance programme. There are also some competitiveness concerns that the tradable sector remains too dominated by the large multinational corporations and not enough by smaller domestic firms.

- **Long-term unemployment is high at more than 60% of total unemployment and youth unemployment is elevated.** This reflects the decline of the construction sector and the difficulty of transferring these skills to other types of employment sectors. The substantial number of long-term unemployed raises the risk that these workers may lose the skills necessary to re-enter the workforce.

This In-Depth Review (IDR) also discusses the policy challenges stemming from these imbalances and the possible avenues to reach balanced growth. Further correcting imbalances would require taking forward the adjustment process started under EU-IMF financial assistance programme. The authorities' positive track record under the programme bodes well for future adjustment. A number of elements can be considered:

- **The sustainability of government debt largely hinges on a further reduction of the still high fiscal deficit**. The 2013 government deficit is estimated at above 7% of GDP. Under the Excessive Deficit Procedure (EDP) Ireland is required to reduce the fiscal deficit to under 3% of GDP by 2015. To achieve this, the planned budgetary adjustment for 2015 would have to be underpinned by high quality structural measures. Beyond 2015, the Irish authorities will be subject to the requirements of the preventive arm of the Stability and Growth Pact (SGP). The government's latest fiscal targets are consistent with this, and if fully met, would achieve the medium-term budgetary objective (MTO) of a balanced budget in structural terms by 2018. This would also ensure the government debt-to-GDP ratio continues to decline and be consistent with the debt rule under the SGP. In terms of multi-annual budgetary planning, limiting discretionary changes to the government expenditure ceiling to a predefined and restricted set of conditions would help in the consolidation process. A careful monitoring of contingent liabilities would also be called for.

- **To sustain economic growth beyond the short term financial sector repair needs to progress further so as to restore the credit channel and reduce the private debt overhang.** Further pursuing mortgage arrears restructuring targets would reduce the high stock of non-performing loans and improve the profitability of banks. Arrears restructuring, in combination with private insolvency arrangements, would further aid the reduction of private and household debt. Improving access to finance for small and medium sized enterprises (SMEs) is also a priority, as lending to enterprises in particular can boost growth. Market-based options to lower the profitability drag from tracker mortgages on banks could also be investigated. Without these reforms the financial sector will not be able to fully support the economic recovery process.

- **The ongoing rebalancing of the Irish economy and the reduction of the high proportion of long-term unemployed could be stepped up by addressing existing labour market issues**. There have been significant advances with labour market activation reforms but additional efforts would be necessary, particularly to boost the delivery of government support services to the unemployed. More progress with further education and training (FET) would also be needed for the reskilling of the unemployed, in particular to ensure that the needs of both employers and jobseekers are satisfied and that the offer of training programmes is underpinned by a strategic plan for the sector.

- **To alleviate the highly negative NIIP, recent competitiveness gains need to be advanced and public finances further adjusted.** A full implementation of fiscal consolidation plans will improve the external position as public external debt declines. Labour market reforms would enhance competitiveness through improving skills while on-going wage moderation is also crucial. A reallocation of resources to the tradable sector would be supported by financial sector schemes that improve financing to domestic SMEs as they export little.

1. INTRODUCTION

On 13 November 2013, the European Commission presented its second Alert Mechanism Report (AMR), prepared in accordance with Article 3 of Regulation (EU) No. 1176/2011 on the prevention and correction of macroeconomic imbalances. The AMR serves as an initial screening device helping to identify Member States that warrant further in depth analysis to determine whether imbalances exist or risk emerging. According to Article 5 of Regulation No. 1176/2011, these country-specific in-depth reviews (IDR) should examine the nature, origin and severity of macroeconomic developments in the Member State concerned, which constitute, or could lead to, imbalances. On the basis of this analysis, the Commission will establish whether it considers that an imbalance exists in the sense of the legislation and what type of follow-up in terms it will recommend to the Council.

In the AMR the Commission briefly discussed the case of Ireland and indicated that its situation in the context of the MIP would be assessed after the end of the EU-IMF financial assistance programme, which coincided with the end of the availability period under the European Financial Stability Facility (EFSM) on 8 February 2014. On the external side, the AMR highlighted the negative net international investment position (NIIP) though this is partly compensated by large inward FDI stocks and driven by government debt levels. On the internal side, high levels of private and government debt remain a concern, along with significant levels of unemployment though this has been declining.

On 18 February 2014 the Council considered that Ireland should be fully integrated in the European Semester framework, including the MIP, and invited the Commission to consider preparing also an IDR for Ireland. This document responds to the invitation of the Council.

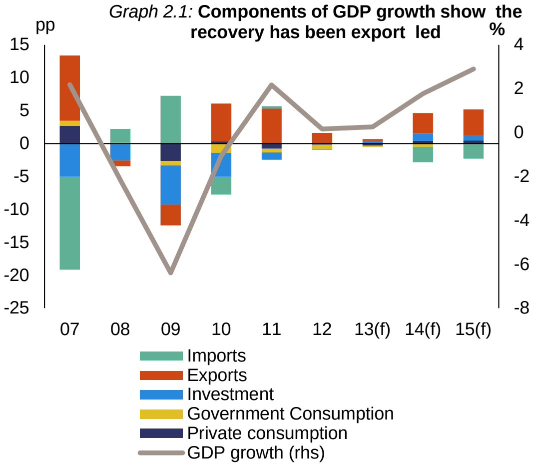
Against this background, section 2 first gives an overview of general macroeconomic developments. Section 3 looks more in detail into the main imbalances and risks, focusing on private sector indebtedness (3.1), general government debt (3.2), financial sector challenges (3.3), competitiveness and sustainability of the external position (3.4), and labour market issues and skills mismatches (3.5). Section 4 discusses policy considerations.

2. MACROECONOMIC DEVELOPMENTS

Growth, labour market, and inflation

The bursting of a large property-market bubble in 2007 pushed the economy into recession. The steep decline in property prices weighed heavily on domestic demand as private households and banks' balance sheets suffered. Moreover, the decline in the construction sector had negative effects on employment and output. After real output loss of 9½% between 2007 and 2010, the economy began to recover thanks to external demand. Domestic demand has remained weak, showing signs of recovery only in 2013. Still over 2011-2013, average annual real GDP growth in Ireland was 0.9%, higher than that in the euro area.

Graph 2.1: **Components of GDP growth show the recovery has been export led**

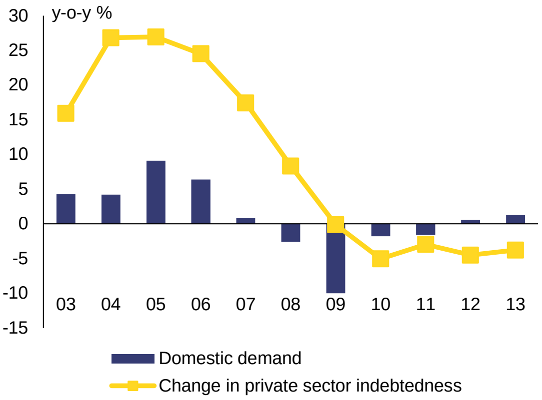


Source: Eurostat

After a sluggish performance in the first half of 2013, growth began to pick up and is estimated at 0.3% for the year as a whole. Weakness in exports and the continuing drag of low private consumption contributed to a year-on-year (yoy) contraction in real GDP of -1.3% and -0.9% in the first and second quarters respectively. Export weakness – particularly of goods exports – reflected difficult economic conditions in key trading partners, as well as the effects of patent expiry for certain high-value pharmaceutical products manufactured in Ireland ('Patent Cliff'). As conditions in trading partners began to improve, and thanks to significant improvements in cost competitiveness, exports accelerated, particularly services, in the third quarter of the year. High frequency indicators for the final quarter of 2013 suggest the economic recovery picked up speed at the end of the year. Early indicators of an increase in investment activity and a stabilisation of private consumption suggest more balanced contributions to growth will underpin the nascent economic recovery.

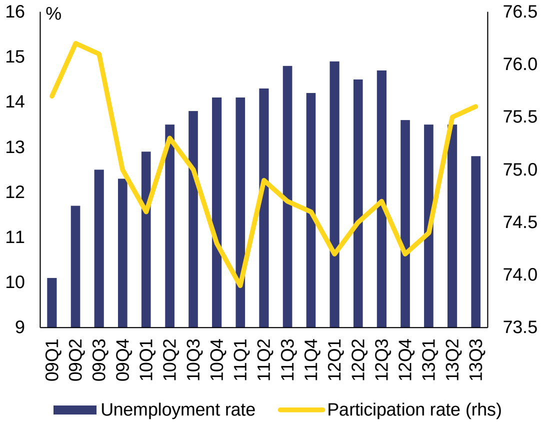
Growth is expected to pick up further. Average real GDP growth in 2014 is forecast at 1.8%, as economic recovery in key trading partners is expected to sustain positive export growth, particularly for services, while further improvements in the labour market and a modest rise in investment, from low levels, are expected to support the domestic economy. In 2015, average GDP growth is projected higher at 2.9%, largely due to growing net exports. Private sector deleveraging will continue to dampen the contribution to growth from domestic demand, but to a lesser extent than in the past (Graph 2.2).

Graph 2.2: **Private sector deleveraging has mirrored the change in domestic demand**



Source: Eurostat, ECB

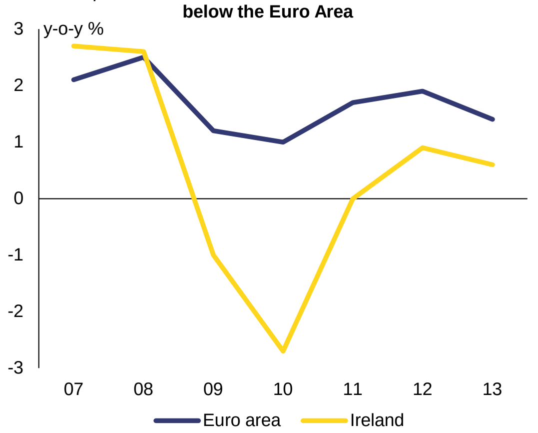
Graph 2.3: **Unemployment has declined while participation increased**



Source: Eurostat

Labour market developments have outpaced improvements in GDP growth. The divergence between stagnant GDP and rising numbers employed was notable in the first half of 2013, as GDP shrank but employment rose. Employment gains were also supported by broader improvements in the labour market with employment gains moving from the part-time sector to the full-time one, while the participation rate has risen (Graph 2.3). The seasonally adjusted unemployment rate remains high, but fell to 12.8% in the third quarter 2013 from a peak of 15.1% in the first quarter of 2012. Faster increases in employment than GDP have led to a decline in productivity, as measured by unit labour costs (ULC). This 'productivity puzzle' is most likely explained by the falling contribution to GDP of goods exports from the pharmaceutical-chemical sector in line with the 'Patent Cliff'([1]).

Graph 2.4: **Core inflation in Ireland has remained below the Euro Area**

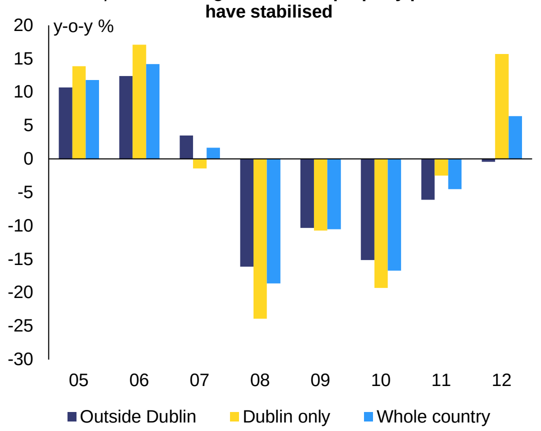


Source: Eurostat

Inflation remains below the euro-area average. Annual core inflation remained subdued in 2013, reflecting low wage pressure and the ongoing process of internal devaluation (Graph 2.4). At 0.5%, 2013 average annual HICP inflation excluding energy remained firmly below the average for the euro area for a fifth consecutive year. This reduction in relative consumer prices supports real competitiveness gains made by Ireland since the onset of the crisis. The largest driver of 2013 inflation in the non-traded sector was higher rents paid by private tenants, which increased by 8.5% in the year to December 2013.

The housing market has stabilised, with signs the Dublin market is diverging from the rest of the country. There are indications that following the large adjustment in house prices, the market is beginning to once again stabilise (Graph 2.5). Some areas of the country, particularly Dublin, recorded double-digit growth in property prices in recent months, though the level of transactions remains low and price movements still appear driven by fundamentals (Box 3.2). Residential rental prices also reflect the emerging two-tier property market, with Dublin average rental prices increasing 7.6% yoy in the year to November 2013, against 1.8% yoy for the rest of the country.

Graph 2.5: **Average residential property prices have stabilised**



Source: CSO

Ongoing fiscal consolidation is expected to have stabilised government debt. The 2013 deficit is estimated at 7.2% of GDP based on cash data, which were slightly better than expected. Consumption-related revenue continued to be weak, while direct tax revenue on labour and corporate income fared better. Overall, the expenditure outturn was broadly in line with budget plans, while some overruns in the health sector were offset by savings elsewhere. Under current growth assumptions, gross government debt as a per cent of GDP is expected to have peaked in 2013 at 122% and is expected to decline to 120% in 2014.

The 2014 general government deficit is projected at 4.8% of GDP. This includes the discretionary measures presented in the

([1]) The effects on headline output from this sector, which accounted for about 12% of gross value added (GVA) in 2012, but only 2% of employment , have likely masked underlying improvements in the more labour-intensive domestic economy. See Enright S and Dalton M (2013).

2014 budget of 1.5% of GDP, and other deficit improving elements, some of which are temporary. Discretionary measures include tax increases on alcohol and tobacco, on bank deposits, on pension fund assets and on financial institutions. Expenditure measures include further public sector wage savings, and tighter eligibility for social benefits and medical services.

In 2015, the general government deficit is projected at 4.3% of GDP on a no-policy change assumption. This means it includes consolidation measures that had been announced with a sufficient degree of detail at the cut-off date of the Commission Services' winter forecast. The cyclically-adjusted budget balance net of one-off and other temporary measures is projected to decline from 6.5% of GDP in 2013 to 4.7% in 2015 ([2]).

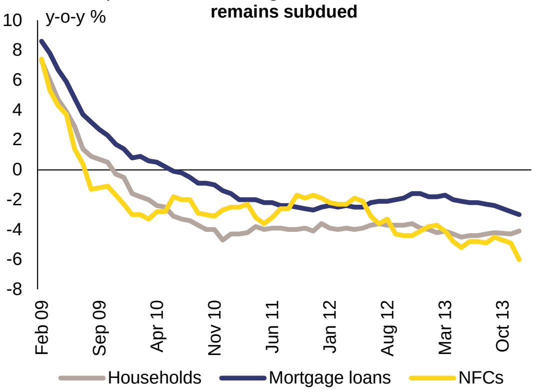
Financial Sector and credit supply

International financial markets have regained confidence in Ireland. On 7 January 2014, within weeks of the successful completion of the EU-IMF financial assistance programme, the Irish sovereign issued a new ten-year bond at a yield of 3.54% (about 30 basis points below the ten-year bond yield of Spain and Italy) with high demand from investors. Irish bonds also rallied following the January 2014 announcement by Moody's to raise the long-term credit rating of sovereign debt to investment grade. Ten-year spreads over Germany stood at around 165 basis points in early February, near record lows, and much below their high of 1143 basis points in mid-July 2011.

In spite of the nascent economic recovery, bank credit to households and non-financial companies (NFCs) continues to fall. December 2013 recorded the sharpest decline in the annual rate for lending for mortgages since the onset of the crisis, bringing the average for 2013 down 3% from 2012. Tight credit conditions, combined with subdued demand, are also reflected in loans to NFCs, which fell by 6% yoy in December 2013.

([2]) One-off measures include guarantee payments related to the liquidation of IBRC in 2013 (0.7% of GDP), revenue from the sale of mobile telephone licenses in 2013 (0.4% of GDP), revenue from the sale of the National Lottery licence in 2014 (0.2% of GDP), as well as financial sector measures for credit unions in 2014 and 2015 (less than 0.1% of GDP in each year).

Graph 2.6: **Bank lending to households and firms remains subdued**



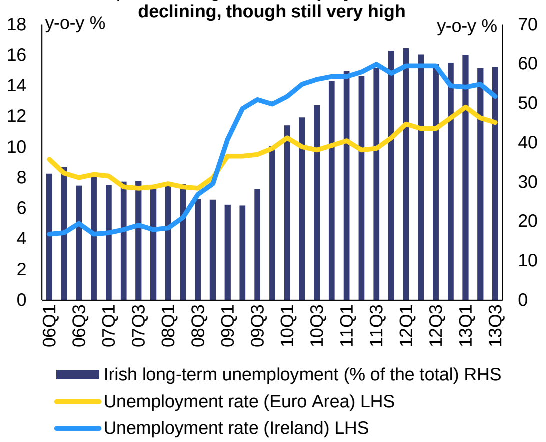
Source: Central Bank of Ireland.

Notes: Data for households is for all credit institutions lending in

Interest rates on new loans remain high. Interest rates on loans to Irish households averaged 3.3% over the twelve months to November 2013, about 40 basis points higher than the corresponding figure for the euro-area. For NFC loans under EUR 1 million, Irish rates averaged 4.6% in 2013, which was even higher than the euro-area average of 3.8% for the same period. Nonetheless, this figure remained below the 2013 average for Spain (5.1%) and Portugal (6.4%), but slightly above that of Italy (4.4%). A slight decline in rates to households in late 2013 was primarily the result of a cut in the ECB's interest rate.

Social Indicators

Graph 2.7: **Long term unemployment is now declining, though still very high**



Source: Eurostat, CSO

Social transfers cushioned much of the immediate impact of the crisis, but poverty

rates are rising, as long-term unemployment has increased**.** The poverty reducing impact of social transfers has been higher in Ireland than for most other EU countries. At-risk-of-poverty (AROP) ([3]) levels initially fell, from 17.2%% in 2007 to 15% in 2009 levelling off at 15.2% for 2010 and 2011. This in part reflected the relative effect of falling wages on poverty thresholds. AROP are now set to rise again as non-core social welfare payments (allowances for maternity, bereavement grants, jobseekers benefit for under 26s and certain allowances for retired people) have been affected in more recent budgets. Severe material deprivation ([4]) rates also rose from 4.5% in 2007 to 7.8% in 2011, but were still below the EU average (of 8.8%).

Income inequality measures have remained largely stable since the onset of the crisis. The S80/S20 income quintile share ratio is below the EU average and fell from 4.8 in 2007 to 4.6 in 2011, indicating less inequality in Ireland, against an increase in the EU over the same period (from 4.7 to 5.1). This may partially reflect the mildly progressive nature of fiscal consolidation in the first years of the crisis, which however has been reversed in more recent budgets.

([3]) At Risk of Poverty rates measure the percentage of the total population whose income is below a set percentage of median incomes for the country, and here it is 60%.

([4]) Severe Material Deprivation is defined as the inability to afford at least four items of a list of nine items deemed necessary to lead an adequate life (for example paying rent, heating or buying meat).

Table 2.1:

Key economic, financial and social indicators - Ireland

							Forecast		
	2007	2008	2009	2010	2011	2012	2013	2014	2015
Real GDP (yoy)	5.0	-2.2	-6.4	-1.1	2.2	0.2	0.3	1.8	2.9
Private consumption (yoy)	6.7	-0.2	-5.4	0.4	-1.4	-0.3	-0.6	0.8	1.0
Public consumption (yoy)	7.1	1.2	-2.9	-4.9	-2.9	-3.2	-1.0	-2.8	-0.4
Gross fixed capital formation (yoy)	2.5	-9.5	-27.0	-22.7	-9.1	-0.6	3.8	10.5	5.4
Exports of goods and services (yoy)	8.4	-1.1	-3.8	6.4	5.4	1.6	0.3	2.8	3.7
Imports of goods and services (yoy)	7.9	-3.0	-9.8	3.6	-0.4	0.0	0.1	2.8	2.6
Output gap	3.7	0.3	-5.0	-4.8	-1.8	-1.0	-1.2	-0.3	0.9
Contribution to GDP growth:									
Domestic demand (yoy)	4.9	-2.3	-9.2	-4.4	-2.4	-0.8	-0.1	1.1	1.1
Inventories (yoy)	-1.0	-1.1	-1.3	0.3	-1.1	-0.6	0.2	0.0	0.0
Net exports (yoy)	1.1	1.2	4.1	3.1	5.7	1.6	0.2	0.7	1.8
Current account balance BoP (% of GDP)	-5.3	-5.6	-2.3	1.1	1.2	4.4	.	.	.
Trade balance (% of GDP), BoP	9.9	9.0	15.8	18.4	21.5	24.1	.	.	.
Terms of trade of goods and services (yoy)	-1.5	-2.3	1.7	-1.5	-2.7	0.3	0.0	-0.1	-0.1
Net international investment position (% of GDP)	-19.5	-75.6	-92.4	-88.0	-112.2	-112.0	.	.	.
Net external debt (% of GDP)	-212.0	-159.6	-212.2	-294.4	-329.3	-396.7	.	.	.
Gross external debt (% of GDP)	812.1	1001.4	1082.7	1091.5	1063.3	1003.5	.	.	.
Export performance vs. advanced countries (5 years % change)	.	.	.	.	.	.	.	.	.
Export market share, goods and services (%)	.	.	.	.	.	.	.	.	.
Savings rate of households (Net saving as percentage of net disposable income)	-0.5	6.0	11.5	8.5	6.4	5.2	.	.	.
Private credit flow (consolidated, % of GDP)	23.9	19.9	-3.8	-1.6	15.3	-1.5	.	.	.
Private sector debt, consolidated (% of GDP)	218.6	256.6	280.6	283.2	300.8	306.4	.	.	.
Deflated house price index (yoy)	4.2	-8.4	-12.7	-10.5	-15.4	-11.7	.	.	.
Residential investment (% of GDP)	11.5	8.6	4.9	3.2	2.5	2.0	.	.	.
Total Financial Sector Liabilities, non-consolidated (yoy)	10.2	6.5	2.9	6.2	-0.7	-0.7	.	.	.
Tier 1 ratio (1)	.	8.0	7.7	7.7	16.3	14.9	.	.	.
Overall solvency ratio (2)	.	12.0	12.8	14.5	18.9	19.2	.	.	.
Gross total doubtful and non-performing loans (% of total debt instruments and total loans and advances) (2)	.	.	.	.	.	.	.	.	.
Employment, persons (yoy)	4.4	-0.6	-7.8	-4.1	-1.8	-0.6	2.2	1.5	1.4
Unemployment rate	4.7	6.4	12.0	13.9	14.7	14.7	13.1	11.9	11.2
Long-term unemployment rate (% of active population)	1.4	1.7	3.5	6.8	8.7	9.1	.	.	.
Youth unemployment rate (% of active population in the same age group)	9.1	13.3	24.0	27.6	29.1	30.4	26.6	.	.
Activity rate (15-64 years)	72.5	72.0	70.6	69.4	69.2	69.2	.	.	.
Young people not in employment, education or training (% of total population)	10.7	14.9	18.6	19.2	18.8	18.7	.	.	.
People at-risk poverty or social exclusion (% total population)	23.1	23.7	25.7	27.3	29.4	.	.	.	.
At-risk poverty rate (% of total population)	17.2	15.5	15.0	15.2	15.2	.	.	.	.
Severe material deprivation rate (% of total population)	4.5	5.5	6.1	5.7	7.8	.	.	.	.
Persons living in households with very low work intensity (% of total population)	14.3	13.7	20.0	22.9	24.2	.	.	.	.
GDP deflator (yoy)	1.7	-2.9	-3.8	-1.5	0.7	0.7	0.6	0.7	1.1
Harmonised index of consumer prices (yoy)	2.9	3.1	-1.7	-1.6	1.2	1.9	0.5	0.8	1.1
Nominal compensation per employee (yoy)	5.6	5.2	-1.1	-3.8	-0.1	0.8	-0.3	-0.6	0.6
Labour Productivity (real, person employed, yoy)	0.6	-1.5	1.6	3.1	4.0	0.8	.	.	.
Unit labour costs (whole economy, yoy)	5.0	6.8	-2.6	-6.7	-4.0	0.0	1.6	-0.8	-0.8
Real unit labour costs (yoy)	3.2	10.0	1.3	-5.3	-4.6	-0.6	1.0	-1.5	-1.9
REER (ULC, yoy)	5.6	7.6	-5.1	-9.8	-4.5	-5.4	3.7	-0.5	-2.0
REER (HICP, yoy)	3.1	3.5	-1.6	-7.2	-1.1	-4.3	1.6	0.4	-0.7
General government balance (% of GDP)	0.2	-7.4	-13.7	-30.6	-13.1	-8.2	-7.2	-4.8	-4.3
Structural budget balance (% of GDP)	-1.7	-7.6	-9.2	-8.9	-8.1	-7.7	-6.4	-4.9	-4.6
General government gross debt (% of GDP)	24.9	44.2	64.4	91.2	104.1	117.4	122.3	120.3	119.7

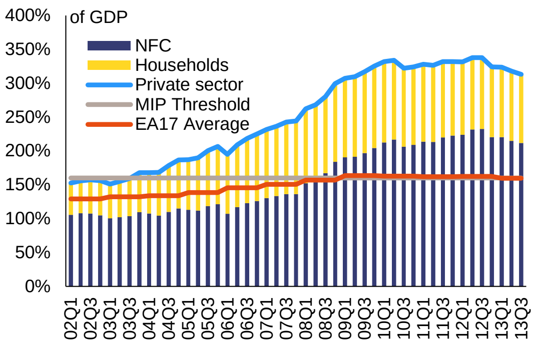
(1) domestic banking groups and stand-alone banks.
(2) domestic banking groups and stand alone banks, foreign (EU and non-EU) controlled subsidiaries and foreign (EU and non-EU) controlled branches.
Source: Eurostat, ECB, AMECO.

3. IMBALANCES AND RISKS

3.1. PRIVATE SECTOR INDEBTEDNESS

Private sector indebtedness in Ireland considerably exceeds the euro-area average but has recently started to decline (Graph 3.1). Between 2009 and 2012 Irish private sector debt-to-GDP increased while it was stable or declined in most other Member States with private sector indebtedness above the MIP threshold (Graph 3.2). However more recently, the Irish private sector non-consolidated debt-to-GDP ratio declined to almost 317% at end-September 2013, its lowest level since the third quarter of 2008. Despite falling by about EUR 48 billion (8.4%) from its peak in the second quarter of 2012, it remains the second highest in the EU. This indicates that the drag on domestic demand due to ongoing balance sheet repair by domestic agents is likely to persist.

Graph 3.1: **Private sector indebtedness considerably exceeds the euro area average**

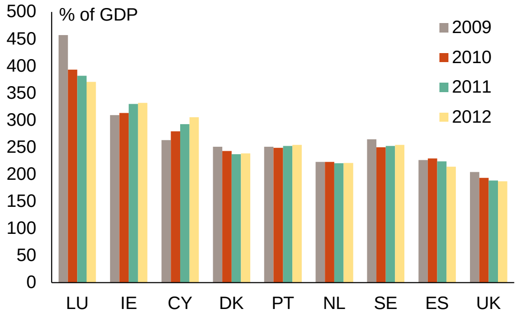


Source: Central Bank of Ireland, Eurostat

Notes: Decomposition of financial liabilities in % of GDP based on a 4QMA. Figures for each sector are the sum of loans and securities other than shares and data is non-consolidated.

However, the aggregate indicator masks important differences in the deleveraging trends of households and enterprises. While households have reduced their debts by about 19 percentage points from their peak of 121% of GDP in late 2009 through raising savings, non-financial corporation (NFC) debt increased by about 7 percentage points over the same period, reaching EUR 350.8 billion (211.6% of GDP) at end-September 2013. More recently this trend appears to have reversed and NFC debts have declined by about 10% since their peak in the third quarter of 2012, though they remain at elevated levels.

Graph 3.2: **Private indebtedness in IE continued to grow in 2009-2012**



Source: Eurostat

Notes: Member States included are all those with private sector debt-to-GDP ratios above the MIP threshold. Figures for each sector are the sum of loans and securities other than shares and data is non-consolidated.

3.1.1. Enterprise indebtedness trends largely driven by the activity of multinationals

The sizeable imbalance in enterprise indebtedness is related to Ireland's large multi-national corporation (MNC) sector. Even though they represent just 2% of Irish-resident firms, MNCs accounted for almost 56% of total turnover and 57.4% of the gross value added of all domestic enterprises in 2011. Given that these firms often finance their activities through intra-group loans, measuring liabilities on an unconsolidated basis – as is the case in the MIP scoreboard – overstates the NFC debt-to-GDP ratios in Member States with large MNC sectors, such as Ireland. On a consolidated basis ([5]) NFC indebtedness relative to GDP in Ireland was more than 25 percentage points lower in 2012 when compared to the non-consolidated level. However, at 306% of GDP, Ireland's private sector was still the second most indebted in the EU and considerably above the euro area average for this indicator (Graph 3.3).

([5]) The latest consolidated figures from Eurostat are from 2012 and are only available annually.

Box 3.1: Tracker mortgages – a structural challenge for Ireland's banks

Despite considerable reductions in funding costs and operating expenses, the pre-provision profitability of Irish banks is structurally challenged. This is mainly due to the high concentration of low-yielding legacy loans – the so-called tracker mortgages, where the interest rate is set at a low fixed margin above ECB or Bank of England (BoE) policy rates – on banks' balance sheets. These loans accounted for a total of about EUR 69 billion (around 56% and 32% of gross mortgages and total loans, respectively) in the three domestic banks at end-June 2013. Most trackers were issued during 2000-08 at a time when there was little divergence between official interest rates and bank borrowing costs. As policy rates began declining and bank funding costs spiked, these loans became loss-making, creating a considerable drag on profits.

The level of arrears in banks' tracker portfolios is relatively low, though options to address their drag on profitability are nonetheless limited. CBI research shows that the arrears rate for variable-rate (non-tracker) customers is 3 to 4 percentage points higher than that for tracker customers ([1]). Thus, incurred losses arising from the performing cohorts of these portfolios are likely to remain relatively low against a background of a protracted period of low projected policy rates. This nonetheless narrows the range of available options to address the tracker problem, as some currently performing trackers are likely at the margins of what is affordable for the borrower. Thus, solutions involving rate increases would seem sub-optimal from a profitability perspective as higher impairment charges would likely erode any potential gains in interest income. In addition, about 16% of trackers are already in arrears, which further narrows the available funding options for these assets.

An administrative or legal solution to the tracker problem does not appear feasible in the Irish context. Borrowers on trackers have no incentive to change their loan conditions given the very low interest rates currently payable on such mortgages. Unlike in some other countries, the contractual arrangements on the majority of these loans also prohibit banks in Ireland from re-setting the interest margin. Consumer protection rules in Ireland until recently prevented lenders from switching customers from trackers into other mortgage products. The review of the Code of Conduct on Mortgage Arrears amended the relevant provisions in this area, permitting modifications of the interest rate-setting mechanism in certain circumstances ([2]). However, given the already vulnerable position of these customers in terms of repayment capacity, it is unlikely that this would significantly reduce the drag of tracker mortgages on banks' balance sheets.

Cross-subsidization on new lending to offset losses on tracker mortgages could have adverse macro-economic implications through further impairing the credit channel. As banks seek to increase net interest margins, new lending at considerably higher interest rates and re-pricing of banks' outstanding loan books (e.g. through increasing standard-variable rates – SVR) are effectively subsidising the unprofitable tracker portfolios. In addition to representing a supply constraint on new credit extension, this cross-subsidisation could thus also have the undesired effect of raising impairments as arrears on existing variable-rate mortgages could increase given the sizeable rises in SVRs introduced by banks in recent quarters.

Capital consumption associated with tracker mortgages could be managed over time. While lifetime losses are material in present-value (PV) terms, it is important to underscore that they need not be recognised upfront. Unless the loans are transferred out at market value, losses will be incurred over time and could be offset by banks' future profits. While the methodology for the upcoming Single Supervisory Mechanism

([1]) Goggin et al. (2012).
([2]) In cases where the lender concludes that none of the options allowing the borrower to retain their tracker are appropriate and sustainable, the lender may offer an alternative arrangement which requires the borrower to change to another mortgage type, but only if that alternative is affordable for the borrower, and is a long-term durable solution consistent with CBI guidelines on sustainability.

(Continued on the next page)

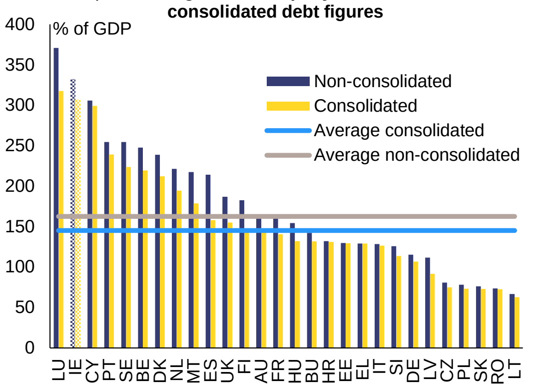
Box (continued)

(SSM) exercise is still under discussion, losses associated with tracker mortgages are considered unlikely to result in capital consumption exceeding available buffers at domestic banks, in part because of the planned time horizon of the exercise. Assuming an unlikely scenario of zero future profits realised by the three domestic banks, the PV of losses associated with their trackers over the next three years is estimated to amount to about EUR 3.5 billion, or an annual drag to CT1 of about 1.25% in aggregate ([3]).

([3]) Main assumptions include (i) an average system-wide tracker interest margin of 1.10%; (ii) ECB policy rate of 0.25%; (iii) marginal funding cost derived from average funding costs provided by banks adjusted for ECB funding of portion of the loans; (iv) average life of tracker portfolios of 25 years.

Research ([6]) on the sources of funding of Irish enterprises indicates that rising debt levels for the sector as a whole over the past three years could largely be attributed to buoyant MNCs which have maintained high levels of foreign-funded investment activity despite the domestic economic downturn (Graph 3.4) ([7]).

Graph 3.3: **Large inter-company loans inflate non-consolidated debt figures**

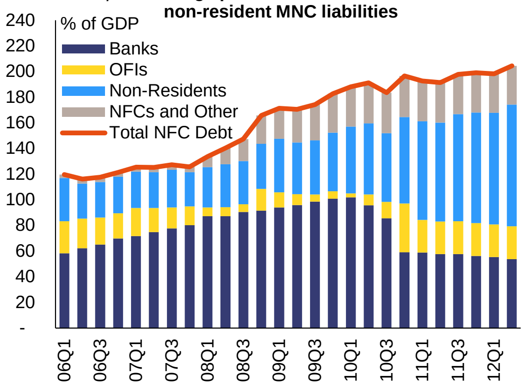


Source: Eurostat

Notes: Latest available annual data (2012) for all 28 EU Member States.

([6]) Cussen and O' Leary (2013).
([7]) Consolidated debt figures do not exclude inter-company loans provided by non-resident entities and securities issued to international investors.

Graph 3.4: **Large part of total NFC debt relates to non-resident MNC liabilities**



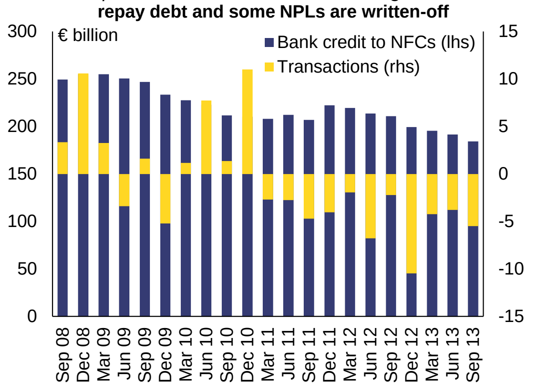
Source: Central Bank of Ireland

Notes: OFI stands for Other Financial Intermediaries and includes NAMA.

While aggregate NFC debt levels have increased during the crisis due to the activity of multinationals, indigenous firms have continued to deleverage. Unlike MNCs, Irish small and medium-sized enterprises (SMEs) are largely reliant on lending from resident credit institutions (Section 3.3.5). Thus, possible credit supply constraints during the crisis partly contributed to the declining stock of credit to the NFC sector, as banks tightened credit conditions in response to liquidity shortages and increasing funding costs. Subdued credit demand from firms is also important as over-indebted SMEs – many of which are still reeling from distressed property exposures – have reduced investment and stepped up loan repayments: since September 2008 Irish enterprises have repaid about 9.6% of credit institution loans in net terms (Graph 3.5). In parallel, banks are working through a high stock of non-performing SME loans (Section 3.3.3), which has resulted in increased provision charges and some debt write-downs, leading to a further reduction in outstanding net lending to the sector. Nonetheless, the declining stock of bank credit to

NFCs has been more than offset by growing international borrowing by Irish multinationals. As the MNC sector is less exposed to a deterioration in domestic economic conditions, the degree of vulnerability for the whole economy caused by the corporate debt overhang in Ireland is perhaps less acute than in other Member States with high private sector debt-to-GDP ratios.

Graph 3.5: **Net credit to NFCs declining as firms repay debt and some NPLs are written-off**

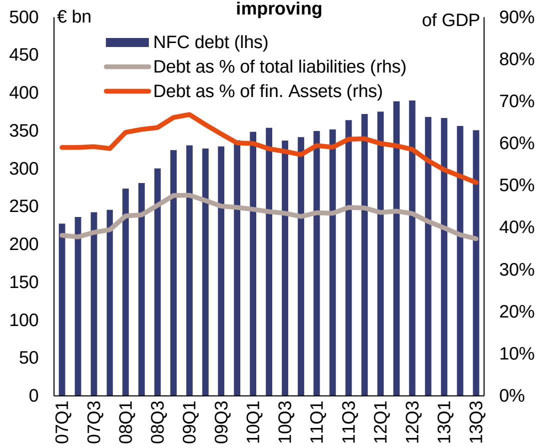


Source: Central Bank of Ireland

Notes: Transactions represent net flows over the quarter, reflecting new debt draw-downs net of repayments.

Alternative measures of NFC debt relative to balance sheet size reveal that the imbalance is also declining. NFC debt as a percentage of total NFC financial assets and of total liabilities has been on a downward trend recently (Graph 3.6). Debt as a percentage of financial assets fell to 50.7% in the third quarter of 2013 largely driven by an increase in NFC financial assets. Debt to total liabilities also decreased further, falling to 37.3% as firms turned to alternative sources of funding including equity issuance and trade finance, which resulted in an increase in total liabilities. In summary, while overall NFC indebtedness in Ireland remains high as a share of GDP, the aggregate debt sustainability of firms is gradually improving.

Graph 3.6: **NFC debt sustainability gradually improving**



Source: Central Bank of Ireland

3.1.2. Household balance sheet repair continues and net worth growth has resumed

Irish households are still among the most indebted in Europe though deleveraging is easing debt burdens despite the fall in disposable income. By end-September 2013, household debt declined by more than 17% from its peak in the fourth quarter of 2008. Still, at 101.7% of GDP, Irish household indebtedness was the second highest in the EU and as a share of gross disposable income (GDI) it was the third highest at 203.7%. Despite a 13% contraction in disposable income, Irish households reduced their debt-to-GDI ratio by 7 percentage points since the start of 2008, more than in most other Member States with household debt-to-GDP ratios above 100% (Graphs 3.7 and 3.8).

Box 3.2: Housing market imbalances have dissipated

The scale of the Irish housing market boom and bust has been nearly unprecedented amongst advanced economies. Between 1993 and 2007, house prices rose by a cumulative 415% ([1]). According to the Central Statistics Office's (CSO) residential property price index, since reaching a peak in early 2007, house prices declined by 51% and hit a bottom in March 2013, though the market began to stabilize around the second quarter of 2012. There is also speculation that the price decline may have been greater as the CSO's data only captures mortgage drawdowns and excludes prevalent cash transactions. Given that the volume of transactions is still very low, caution should also be exercised when interpreting recent price developments.

The recent pick up in residential prices masks regional differences, with Dublin driving these gains and prices still falling outside the capital. For example, in December 2013, residential prices in Dublin were up 15.7% yoy, raising fears of a new housing boom, while in the rest of country they were down 0.4% yoy. This rise in Dublin prices is being driven by its greater economic activity and higher employment rate. There is also a shortage of supply of new properties in Dublin. Just over 2,600 properties were on the market in Dublin in December 2013, a drop of almost 170% since early 2008 ([2]). Moreover, there are about 10,000 first-time buyers in Dublin and only about 1000 units built each year. Vacancy rates have also declined and are much lower in Dublin compared to the rest of the country.

Regression analysis reveals housing market imbalances have subsided and suggests prices may have even undershot somewhat their desirable levels. A recent study carried out by the Commission services focusing on the fundamentals of the housing market has the equilibrium house price determined by real personal disposable income per capita, the lagged housing stock, population, the real mortgage rate, and a proxy for credit conditions ([3]). All the coefficients on the explanatory variables have the expected signs and the model is robust. This paper estimates that the 2013 average house price is undervalued by approximately 13% from its equilibrium price.

Affordability and price-rent ratios generally suggest house prices have moved towards their fundamental values ([4]). In spite of a significant drop of private household's income in the wake of the crisis, the price-to-income ratio reveals that prices have become much more affordable than when they peaked in 2007 (Graph 1). Income per capita fell by about 15% during the recession, as opposed to a 50% drop in house prices. This ratio is also currently about 13% below its long-term historical average. Alternative sources point into the same direction: the affordability for first-time buyers at end-2013 has also improved by more than 50% since end-2006. The price-to-rent ratio has declined since 2007 as house prices fell more than rents, making buying a property more attractive relative to renting, though more recently house prices have picked up more than rents on average. This ratio has moved towards its long-term average but still lies a bit above it suggesting house prices may not be so cheap.

([1]) OECD (2011)
([2]) Daft.ie House Price Report – 2013 Q3.
([3]) Langedijk and Tatar (2013).
([4]) These ratios have certain caveats in providing accurate estimates of imbalances. For example, they do not take into account changes in interest rates over time which can change the equilibrium level of house prices.

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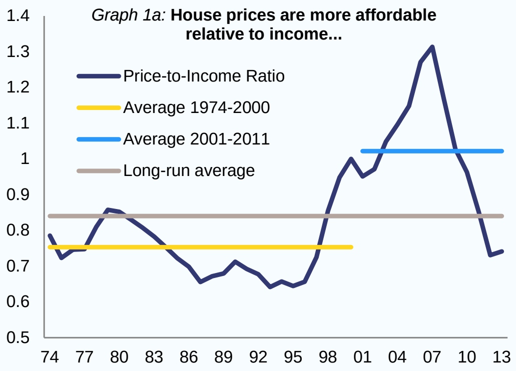
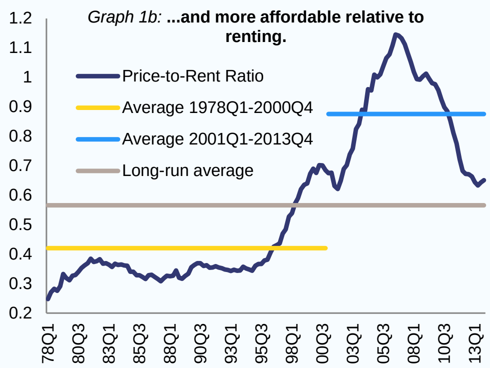
Box (continued)



Source: CSO, Dept of Environment, Community and Local Government

Notes: Yearly average nominal house prices and personal disposable income per capita.



Source: CSO, Dept of Environment, Community and Local Government

Notes: CSO consumer price index sub indices, quarterly average nominal house prices.

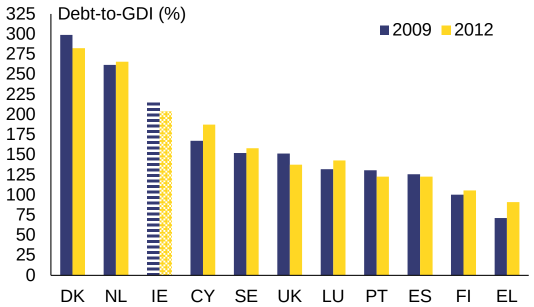
Financial sector reforms should improve the outlook for and the stability of the Irish housing market in the medium term. Recent changes to the regulatory framework, including the revision of the Code of Conduct on Mortgage Arrears and the reformed bankruptcy and personal insolvency regimes, should facilitate the durable restructuring of non-performing mortgage loans. The establishment in 2013 of mortgage arrears resolution targets (MART) for banks has prompted them to offer more solutions to customers though the share of sustainable restructurings has only recently started to modestly increase. There have also been recent amendments of the Land and Conveyancing Law Reform Act that remedied a lacuna preventing the effective realisation of collateral by lenders in certain circumstances. The enactment of the Central Bank (Supervision and Enforcement) Act 2013 strengthening the supervisory powers of the CBI, and the implementation of a central credit register should also help enhance banks' credit standards and avoid the recurrence of housing market booms in the future.

Recent changes in the fiscal regime may also help stabilize the property market in the future. At the end of 2012, mortgage interest relief was abolished and the following year, a market-based recurrent tax on residential property was introduced that compensated for a reduction in the stamp duty on real estate transactions. There is evidence that reforms that lower mortgage interest relief can result in lower loan-to-value ratios while higher rates of property taxation can limit housing booms but overall the findings are not conclusive ([6]).

The housing market should continue to recover with rising employment but high levels of mortgage arrears and low levels of bank credit should avoid the recurrence of another boom. Policies should aim at boosting the supply of housing in Dublin to avoid steep price rises there. It remains unclear whether the nascent recovery in residential property prices will be sustained, with potential increases in supply. Further resolving mortgage arrears will also limit new housing supply as finding sustainable restructuring for more mortgages should allow individuals to remain in their homes. This would also support prices and underpin the recovery in domestic demand.

([6]) Crowe et al. (2013).

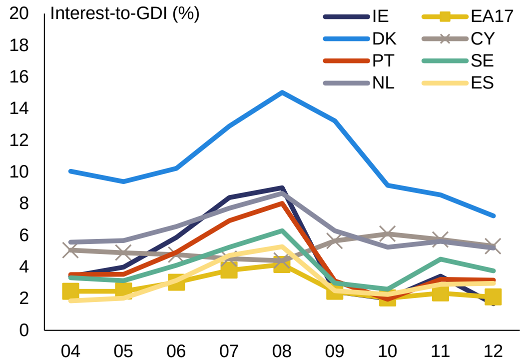
Graph 3.7: **Despite falling DI, IE HH debt-to-GDI declined more than in most other MS**



Source: Central Bank of Ireland, Eurostat

Notes: HH debt-to-GDI ratio includes debt of HHs and NPISHs, as a % of their GDI. Debt is the sum of loans, debt securities and pension fund reserves liabilities. GDI is the four-sum MA of quarterly GDI. Member States included are all those with household debt-to-GDP ratios of over 100%.

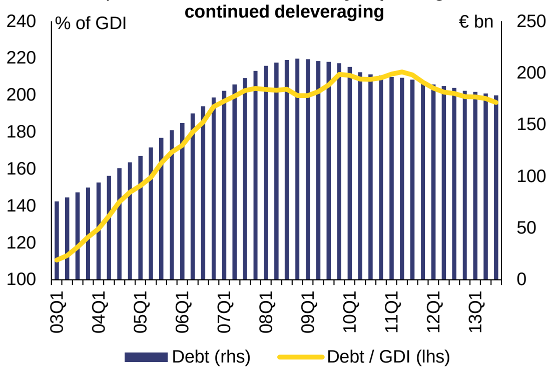
Graph 3.9: **Debt service burden in IE lower than EA average and other MS with indebted HHs**



Source: Eurostat

Notes: Interest includes total interest expense by households, including on mortgage and consumer debt.

Graph 3.8: **HH debt sustainability improving amid continued deleveraging**



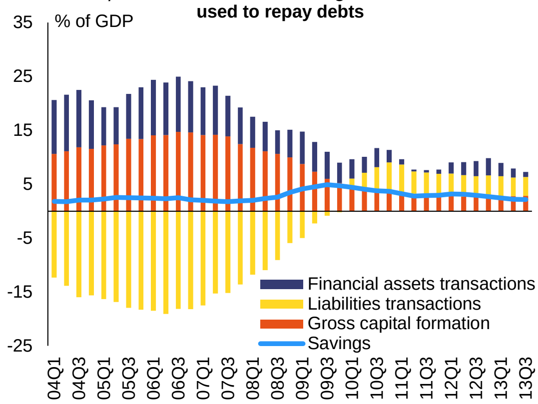
Source: Central Bank of Ireland, CSO

Notes: Household debt is equal to total loans of households. Disposable income is gross disposable income of households including non-profit institutions serving households.

As employment gains support disposable income and deleveraging continues household debt sustainability should improve further. Irish households' debt service burdens compare favourably with those in other Member States (Graph 3.9). This is partly due to "tracker" mortgages (Box 3.1), which account for over two thirds of all Irish mortgage loans. As they are priced at a low fixed margin over central bank policy rates they are protecting borrowers from rate increases passed through from higher bank funding costs. In addition, recent initiatives from some banks to achieve sustainable arrears resolution through partial debt relief offers to distressed mortgage holders should also contribute to reducing household indebtedness.

Higher household savings are being used for debt reduction and thus entail a drag on future consumption. Central bank analysis ([8]) indicates that the largest share of household savings continues to be used for liability transactions reflecting net debt repayments (Graph 3.10). Household savings have slowly declined since 2009. However, they are now about 50% lower relative to their peak in the third quarter of 2009.

Graph 3.10: **Households' savings continue to be used to repay debts**



Source: Central Bank of Ireland, CSO

Notes: Gross capital formation consists of acquisitions of fixed assets less disposals, and includes property acquisitions.

([8]) Cussen M., O'Leary B. and Smith D. (2012).

Box 3.3: Improvements in the fiscal framework

The economic crisis exposed the shortcomings of the past budgetary planning. While the track record of annual budget control was good in Ireland, multi-annual budgetary planning was ineffective. Fiscal plans for outer years were regularly revised upwards and resulted in high expenditure growth rates above 10% on average in 2001-2007 – above the high nominal GDP growth rates during the period of the property-bubble economy. This contributed to the significant deterioration of the fiscal position in the economic downturn in 2008.

Improvements in medium-term budgetary planning begun and complemented the start of fiscal adjustment in 2009. Under the EU-IMF-supported programme, work on comprehensive reform of the medium-term budgetary framework progressed. The reform process ran in parallel with the evolution of the EU fiscal governance framework, with the implementation of the "six-pack", the "two-pack" and the Fiscal Compact ([1]). This put Ireland among the early adopters of the new EU framework.

Ireland has taken many steps to improve the fiscal framework over the last few years.

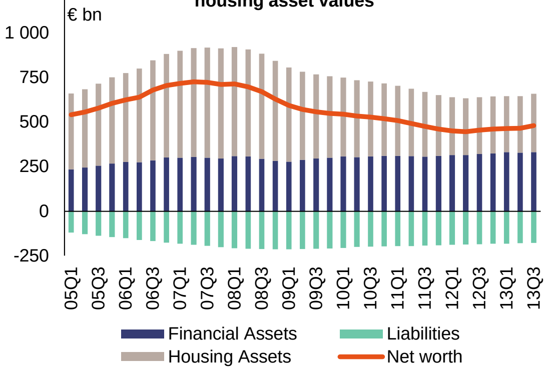
- *The Fiscal Responsibility Act (2012)* introduced the national budgetary rule and implemented an Irish Fiscal Advisory Council (IFAC) on statutory basis. IFAC assesses the official economic and budgetary forecasts, compliance with budgetary rules and the appropriateness of the government's fiscal stance.
- Ministerial expenditure ceilings for three years on a rolling basis were introduced on an administrative basis in 2012 and were put on a statutory footing by the *Ministers and Secretaries (Amendment) Bill (2013)* with operational details outlined in the administrative circular, *Medium-Term Expenditure Framework*.
- The *Medium-Term Budgetary Framework* document, published in December 2013, provides an overview of the set of arrangements, procedures, rules and institutions that underlie the conduct of budgetary policies of general government.
- Fiscal data provision and transparency has improved with quarterly publication of general government finance statistics and monthly cash reports for the central government against the budgetary targets for all main revenue and expenditure items. Data quality has been improved and efforts in this area continue.

Nonetheless, some areas of the fiscal and medium-term budgetary framework need to be further improved. Fiscal plans beyond the annual budget need to be supported by more concrete, broad budgetary measures. Expenditure ceilings are still subject to discretionary changes, as rules for specific adjustment conditions are not legally binding. Restricting these discretionary changes would increase the importance of the multi-annual budgetary planning over the annual budget decisions. Fiscal disclosure remains somewhat fragmented and diffuse, as detailed reports by different government entities across multiple documents with varying frequencies and on a range of different accounting bases provide only partial coverage of the general government. Therefore, fiscal data reporting on general government basis could be expanded, also recognizing all assets and liabilities, as well as improving the analysis of forecast changes, long-term trends, and fiscal risks.

([1]) The "six-pack" reforms in 2011 strengthened both the fiscal surveillance and enforcement provisions of the SGP by adding an expenditure benchmark, operationalizing the debt criterion, introducing a system of financial sanctions for euro area Member States, and setting new minimum standards for national budgetary frameworks. The "two-pack", effective from 2013, introduced additional surveillance and monitoring procedures for euro area Member States. The Fiscal Compact within the inter-governmental Treaty on Stability, Coordination and Governance (TSCG) complements, and in some areas enhances further, key provisions of the SGP.

Household net worth has resumed its upward trend as the value of housing assets has started increasing and liabilities have declined ([9]). Housing assets recorded an increase of 3.5% during the third quarter of 2013, the largest quarterly rise since the third quarter of 2006. This helped push up household net worth to about EUR 485 billion or over 290% of GDP (Graph 3.11). While these positive developments may continue in the near term, it remains unclear whether the nascent recovery in residential property prices will be sustained, particularly with potential increases in supply in the context of ongoing mortgage arrears resolution (Box 3.2).

Graph 3.11: **HH net worth increases due to rising housing asset values**



Source: Central Bank of Ireland, CSO, Department of Environment, PTSB/ESRI house price index

Notes: Net worth measured as the difference between the sum of financial and housing assets of households less their liabilities.

To conclude, Irish private sector indebtedness, though high, is less problematic when considered in the context of country-specific characteristics and the improving debt sustainability of domestic agents. As regards the corporate sector, the large share of multi-national firms in Irish economic activity inflates the aggregate debt-to-GDP figure without necessarily increasing associated vulnerabilities for the domestic economy. On the contrary, buoyant MNC investment during the downturn, supported by non-resident funding, has continued to cushion the adverse impact on growth caused by ongoing balance sheet repair by indigenous enterprises. The household sector has been deleveraging since the onset of the crisis and debt burdens are gradually easing, supported by low average mortgage interest-costs, falling debt levels and recent increases in employment. At the same time, household net worth continues to rise due to a gradual recovery in property prices.

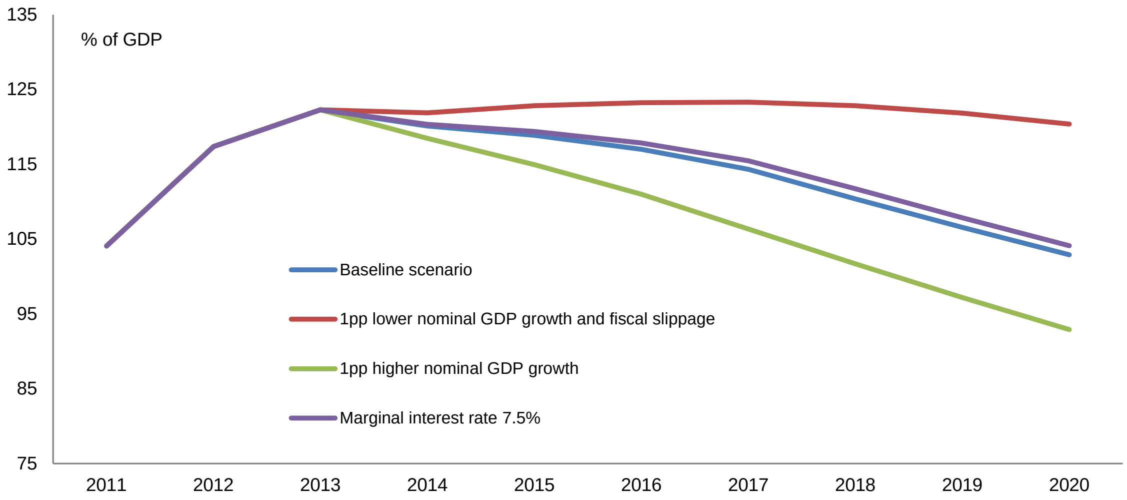
3.2. GENERAL GOVERNMENT DEBT

Irish gross government debt has increased from 25% of GDP in 2007 to an estimated 122% of GDP in 2013. This sharp increase reflects the severe impact the collapse of the property market and the ensuing economic and financial crisis had on public finances. Public debt rose due to sizable banking support measures, the large drop in property-related government revenues and rising interest servicing costs (Graph 3.13). An additional factor contributing to the increase in the gross debt-to-GDP ratio was the increase in precautionary cash balances. However, partial use of the government's rainy day fund – the National Pension Reserve Fund (NRPF) for bank support alleviated some of the borrowing needs.

A gradual and balanced fiscal adjustment path has been followed in order to restore sustainability of public finances. Fiscal consolidation began mid-2008, and from the beginning it sought to strike the appropriate balance between fiscal sustainability and growth concerns by giving, to the extent possible, priority to growth-friendly consolidation measures. The fiscal adjustment was more expenditure-based, including through wage reductions and better-targeting of welfare spending. Property taxation has been shifted from taxing transactions to recurrent revenue streams based on the value of housing. Environment-friendly taxation was expanded and the income tax base was broadened, while maintaining the overall progressivity of the measures, which has contributed to the social acceptance of the overall adjustment. The authorities have also implemented a series of reforms to improve the domestic fiscal framework (Box 3.3).

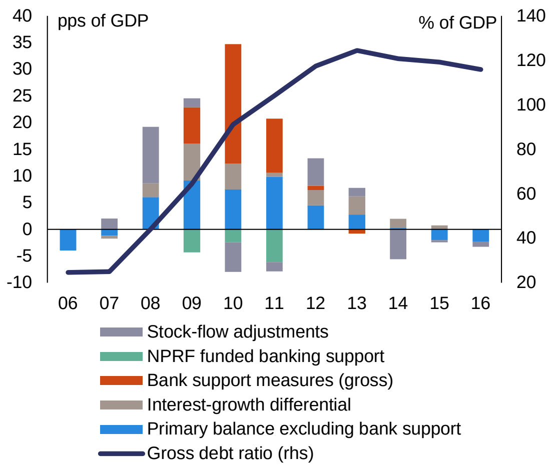
([9]) Household net worth is computed as the sum of household financial and housing assets minus total household liabilities.

Graph 3.12a: **Gross government debt projections**



Source: Commission services
Notes: The baseline scenario assumes observing the fiscal deficit ceiling of 3% of GDP in 2015 and reducing the general government deficit in line with the adjustment path presented in the Medium-Term Economic Strategy, i.e. reaching the balanced structural budget position (MTO) in 2018 and maintaining it thereafter. The calculations assume zero output gap. The assumptions beyond 2016 include real GDP growth of 2.9% (4.0% nominal growth) and the marginal interest rate on new government bonds of 5.5%. Some 10% of the general government debt, including short-term debt, local government debt and other general government liabilities are assumed to remain unchanged/rolled-over at constant interest rates.
The stress scenario assumes a 0.5 sensitivity of the fiscal balance to GDP. In the lower growth scenario with no policy response (represented by the red line), the planned annual fiscal consolidation effort until 2015 is maintained.

Graph 3.13: **Contribution to change in gross government debt**



Source: Commission services' estimates

Government debt is projected to decline from its peak in 2013 as primary surpluses are achieved and economic growth picks up. In 2014, the primary fiscal position is expected to be in balance, though the reduction in debt-to-GDP ratio will mostly be due to a decline in the high precautionary cash balances (from around 11% of GDP at end-2013 to 6% of GDP by end-2014)([10]).

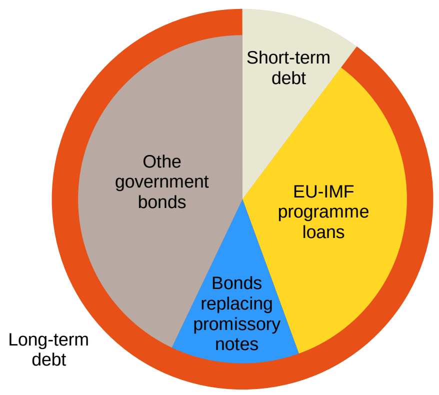
The Commission Services' baseline scenario for debt sustainability (based on the 2014 winter forecast) implies a steady reduction of public debt to 103 % of GDP by 2020 (Graph 3.12). The baseline scenario is predicated on a relatively quick acceleration of economic activity with real GDP growth returning to 2.9% per year as of 2015 (Graph 3.17). Debt sustainability analysis reveals that the government-debt-to GDP ratio is most sensitive to a combined shock of lower economic growth and lower fiscal consolidation. Specifically, if economic growth was 1 percentage point lower than the baseline and the deficit about 0.6 percentage points higher, the fiscal deficit would be 4.1% of GDP in 2015 and it would decline to below the 3% of GDP threshold only in 2018. This would raise the government debt to GDP ratio to 123% in 2016-17 before declining. The sensitivity of government debt to a rise in interest rates on new borrowing is estimated to be low, given low future refinancing needs.

([10]) Change in the cash balances is reflected in stock-flow adjustments in Graph 3.12, which account also for other smaller financial operations including debt management operations.

Government debt is largely long-term and at low interest rates ([11]). Long-term debt comprises some 90% of gross debt, of which around 38% of long-term debt is from official loans from the EU-IMF programme partners (graph 3.14). The lending rate margins on the EFSM and EFSF debt were eliminated and the average maturity extended from 7.5 to 12.5 years in 2011 and again to 19.5 years in 2013, enhancing the sustainability of Ireland's public debt. Moreover in 2013, long-dated government bonds with low floating interest rates replaced the shorter-dated promissory notes at the time of the IBRC liquidation. The interest rate on these bonds is linked to euribor plus a spread of 250 basis points and they will mature between 2038 and 2053 ([12]). These bonds are held by the CBI and will be sold to the market. Consequently, the average maturity of long-term debt stood at about 12 years at end-2013 ([13]). The average interest on government debt is estimated at around 4% at end-2014. Its low level is related to the high proportion of official debt and the long-dated government bonds with floating interest rates. While interest rates on these bonds may rise, the effect on the government balance would be mitigated through the repayment of part of the income back to the sovereign.

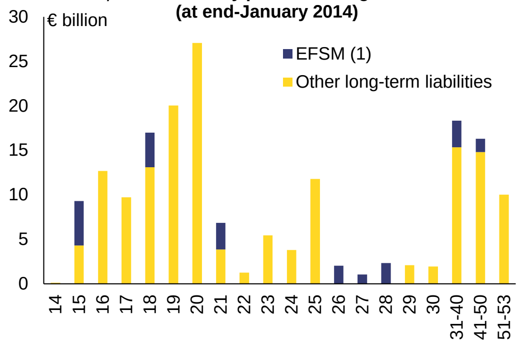
([11]) Long-term debt is defined as debt with an original maturity of over one year.
([12]) The long-dated government bonds that replaced the promissory notes have reduced the government funding needs and provide interest savings. For full analysis of the impact of this operation, see Box 1 in http://ec.europa.eu/economy_finance/publications/occasional_paper/2013/pdf/ocp131_en.pdf.
([13]) This does not reflect the extension of the EFSM loan maturities (see Graph 3.15). Including the EFSM loan maturity extension, the average maturity of long-term debt is estimated at around 13 years.

Graph 3.14: **Composition of the gross government debt**



Source: Commission services' estimates

Graph 3.15: **Maturity profile of long-term debt (at end-January 2014)**



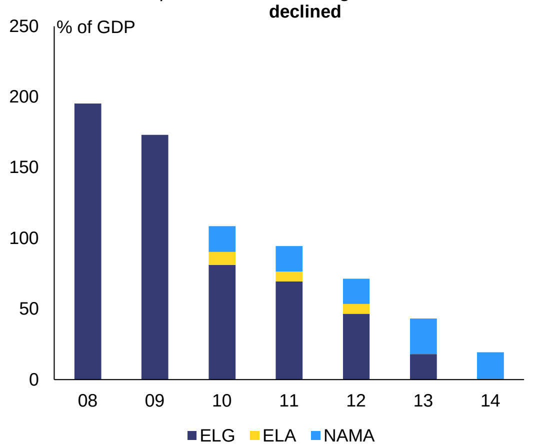
Source: National Treasury Management Agency

Notes: (1) The European Financial Stabilisation Mechanism (EFSM) loans are subject to a seven year extension that will bring their weighted average maturity from 12.5 years to 19.5 years. The revised maturity dates of individual EFSM loans will be determined as they approach their original maturity dates.

Contingent liabilities assumed during the financial crisis have declined, but remain sizable. The blanket guarantee of bank liabilities (including large deposits) was an emergency measures introduced unilaterally by the Irish government in 2008 with the aim to prevent a systemic crisis in the Irish banking sector. This guarantee expired after two years and was succeeded by the Eligible Liabilities Guarantee (ELG) scheme. This guarantee, though still significant, has been declining (graph 3.16). The ELG scheme was closed to new liabilities in March 2013 and the outstanding amount will fall further as guaranteed liabilities mature. Exceptional Liquidity Assistance (ELA) was the central bank's policy instrument, under which loans guaranteed by the government were provided to credit institutions for liquidity support. After the

IBRC's liquidation, ELA is no longer used. Government guaranteed bonds issued by the Special Purpose Vehicle of the National Asset Management Agency (NAMA) were used to acquire commercial property loans from the domestic banks. The NAMA guarantees are expected to persist in the medium term.

Graph 3.16: **Government guarantees have declined**

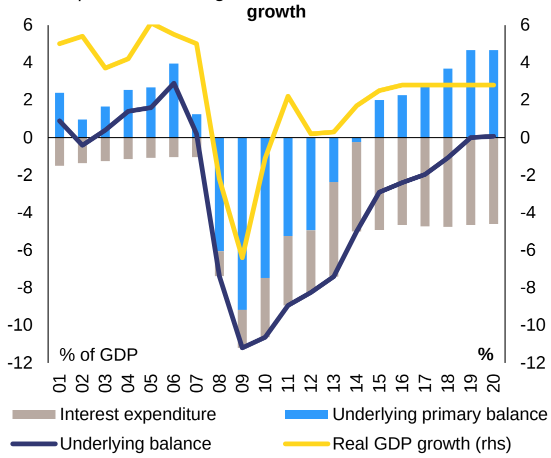


Source: Eurostat, Commission services' estimates

Other Irish non-crisis related contingent liabilities are significant, but also common to other EU countries. Other government guarantees include the Deposit Guarantee Scheme ([14]) (around 50% of GDP in 2011), callable capital in the European Financial Stability Facility (EFSF), the European Stability Mechanism (ESM) and the European Investment Bank (totalling around 13% of GDP in 2012). There are also other open-ended commitments, as the Insurance Compensation Scheme for the insurance industry ([15]). Off-balance sheet Public-Private Partnership (PPP) projects amount to some 3% of GDP in contractual value in 2013, but more projects are in the pipeline. The use of PPP projects reduces short-term financing needs of the government and spreads the public costs over a longer period of time.

Ireland's fiscal adjustment is on track, though further fiscal effort is needed. Ireland is required to reduce the fiscal deficit below 3% of GDP by 2015 under the Excessive Deficit Procedure (EDP). So far, fiscal adjustment has been in compliance with the EDP recommendation and the procedure has been in abeyance since August 2011. While the 2014 overall adjustment is in line with the April 2013 stability programme, the somewhat lower discretionary effort in 2014 means that, at current macro projections, a higher structural effort is required in 2015 to ensure a timely correction of the excessive deficit. The Commission services estimate that a further fiscal adjustment of around EUR 2.5 billion is required in 2015 to bring the deficit below 3% of GDP. Further details are expected to be made public in the 2014 Stability Programme (by end-April 2014) and the 2015 draft budgetary plan (by 15 October 2014). Government's announcements of possible tax cuts in 2015 need to be reconciled with the planned adjustment path.

Graph 3.17: **General government balance and real GDP growth**

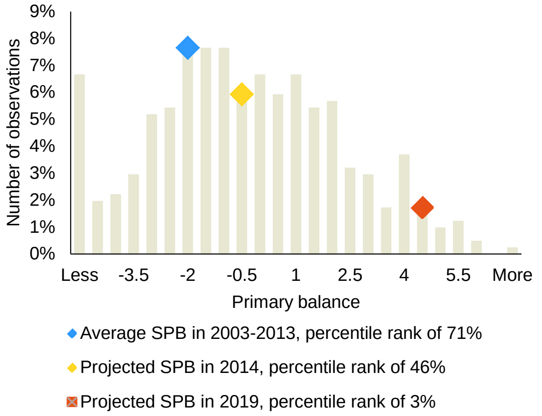


Source: Commission services' estimates

To keep the debt ratio on a declining path, fiscal consolidation needs to continue in the medium term. After exiting the EDP, Ireland will be subject to the rules of the preventive arm of the Stability and Growth Pact (SGP). The authorities plan to attain their MTO of a structural budget balance by 2018 which would be consistent with the SGP rules. If this is to be achieved with a constant revenue-to-GDP ratio it implies a significant reduction of government expenditure relative to GDP. Under current projections, the balanced budget in 2018 would imply a structural primary surplus of 4.8% of GDP. This is quite an ambitious plan relative to past experience across Member States (only 3% of observations for other Member States had higher structural budget balance in the past; Graph 3.18).

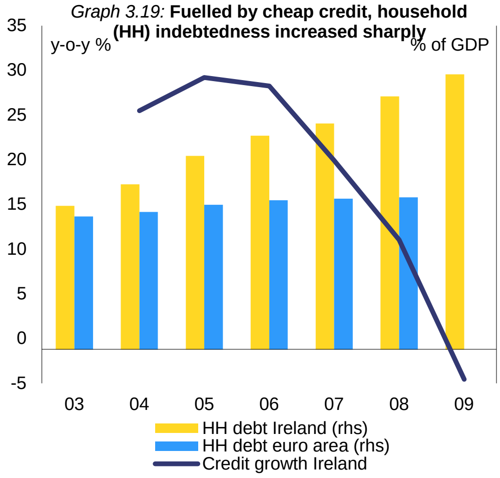
([14]) This covers small deposits of up to EUR 100,000.
([15]) For more details see Fiscal Transparency Assessment: http://www.imf.org/external/np/sec/pr/2013/pr13258.htm.

Graph 3.18: **Ireland's Structural Primary Balance (SPB) compared to other Member States, 1998-2013**



Source: Commission services' estimates

Graph 3.19: **Fuelled by cheap credit, household (HH) indebtedness increased sharply**



Source: Central Bank of Ireland

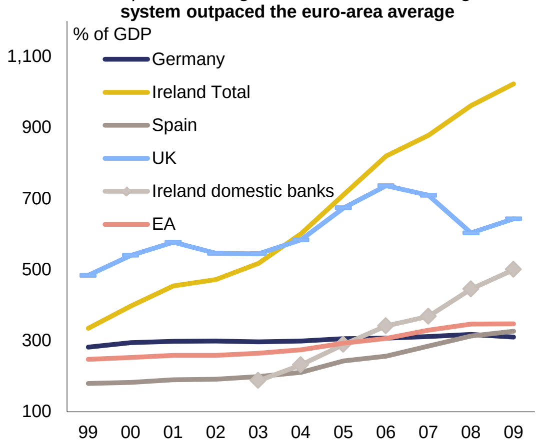
3.3. FINANCIAL SECTOR CHALLENGES

3.3.1. The build-up of imbalances in the Irish financial system

Fuelled by low-cost market liquidity in the run up to the crisis, significant imbalances built up in the Irish banking sector ([16]). Amid intense competition for profits and market shares in an overheating economy and property market, the pace of credit expansion accelerated sharply. This was accompanied by loosening credit standards, and 'light-touch' macro-prudential regulation and supervision did little to stem the swelling banking sector imbalances. The annual growth rate of loans to Irish households was close to 30% in 2004-2006 (Graph 3.19). As a result of the credit boom concentrated in the construction sector Irish banks accumulated large property-related exposures – their share in total bank assets increased from less than 40% in 2002 to over 60% in 2006 ([17]). This led to a sharp deterioration in banks' asset quality after the burst of the housing market bubble.

The rapid expansion of the banking sector reflected the build-up of large external liabilities. Domestic banks' total assets reached around 500% of GDP in 2009 (Graph 3.20), having increased by almost 200 percentage points since 2006. This growth rate by far outpaced the inflow of deposits and average loan-to-deposit ratios peaked at about 210% in late 2008 (Graph 3.21b). The emerging funding gap was closed through increasing reliance on market liquidity: Irish banks' net indebtedness to non-resident entities grew from about 10% of GDP in late 2003 to 60% of GDP in 2008. This exposed the vulnerability of Irish banks' funding structure to rapid changes in market sentiment.

Graph 3.20: **The growth of the Irish banking system outpaced the euro-area average**

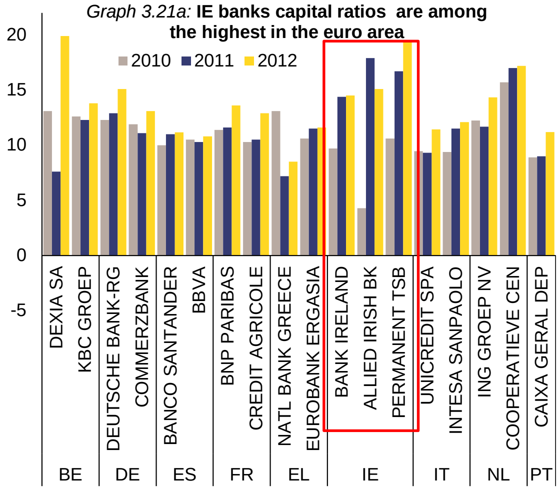


Source: Eurostat, European Central Bank

([16]) The Irish banking sector includes two distinct components: (i) domestic credit institutions which at end 2010 held more than 55% of total bank assets and provided about 95% of total loans to the domestic private sector; and (ii) non-domestic banks from the large offshore financial centre (IFSC), which focused on lending to non-residents and purchases of securities.

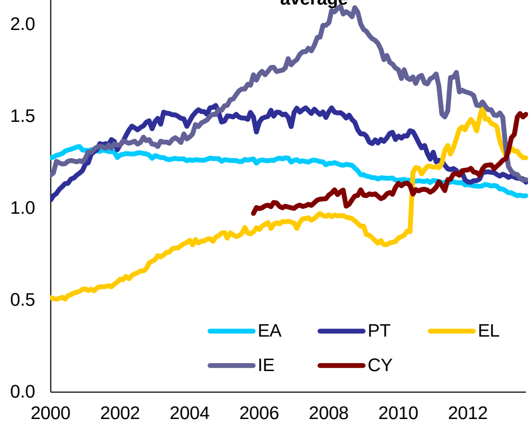
([17]) Honohan (2010).

Graph 3.21a: **IE banks capital ratios are among the highest in the euro area**



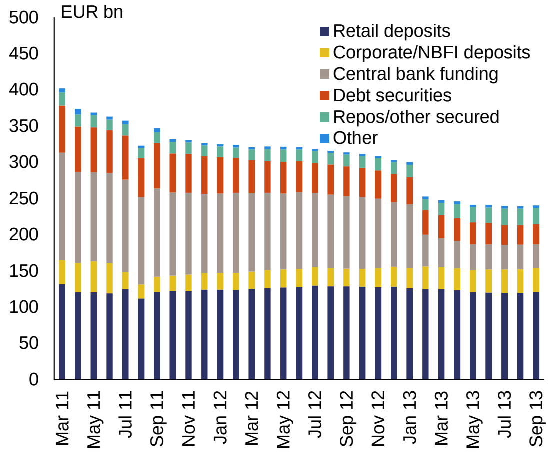
Source: Bloomberg

Graph 3.21b: **IE bank LDRs are below other programme countries and trend to the euro -area average**



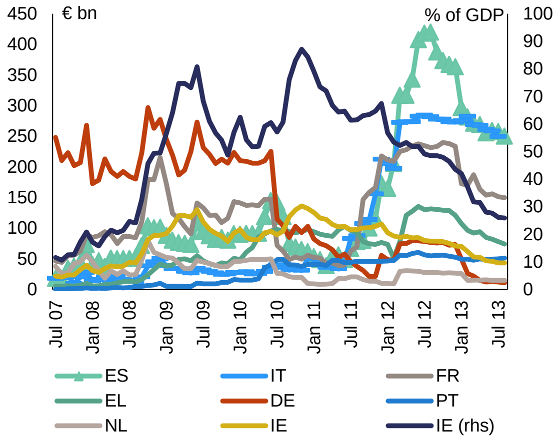
Source: IMF

Graph 3.21c: **IE banks' liabilities are normalising**



Source: Central Bank of Ireland

Graph 3.21d: **Eurosystem borrowing is below pre-programme levels**



Source: National central banks, AMECO

3.3.2. Programme achievements and remaining challenges

Under Ireland's programme the domestic banking sector was restructured, downsized and recapitalised. Since end-2010, two banks have been merged and two others resolved. After one of the largest recapitalisations by the general government in terms of share of GDP in advanced economies ([18]), Irish banks continue to have some of the highest capital ratios in the euro area (Graph 3.21). Oversized bank balance sheets have been deleveraged with loan-to-deposit ratios (LDRs) gradually converging to the euro-area average.

([18]) The total bank recapitalisation cost for the government amounted to about EUR 64 billion, or approximately 41% of 2011 GDP. The EUR 16.5 billion recapitalisation cost determined by the 2011 Prudential Capital Assessment Review (PCAR) stress test was considerably lower than initial estimates. The private sector shared in the bank rescue cost through liability-management exercises on subordinated debt and shareholder losses.

Box 3.4: **Reform of the Irish regulatory and supervision frameworks during the programme**

To address failings in the run up to the crisis the Irish regulatory and supervisory frameworks were strengthened during the programme. This contributed to safeguarding financial stability and established the conditions for effective crisis prevention in the future. The main reforms are outlined below.

A special resolution regime was established to regulate the orderly wind-down of Irish banks and credit unions. The Central Bank and Credit Institutions (Resolution) Act 2011 conferred on the CBI the powers required to undertake the necessary restructuring of Ireland's troubled financial sector. It created a new independent resolution function at the CBI including powers to establish a 'bridge bank' to temporarily hold assets and/or liabilities of entities in resolution, to require troubled institutions to prepare recovery plans, and – following High Court approval – to order the transfer of certain assets and/or liabilities and to appoint a special manager to take over an institution's business. The Act also provided for the establishment of a resolution fund financed by the sector, to which the government could also contribute as necessary.

The bankruptcy and personal insolvency frameworks were reformed to support the resolution of unsustainable household debts and ensure balanced incentives between creditors and debtors. The period of discharge from bankruptcy was shortened from 12 to 3 years to align it more closely with other jurisdictions (e.g., the UK where it is just one year), while the personal insolvency reform provided for three out-of-court debt settlement processes and for the establishment of the Insolvency Service of Ireland. It also introduced protections for debtors' principal private residence. Other legislation was also amended to remedy a lacuna which had limited banks' capacity to recover property collateral in certain circumstances.

The CBI's supervision and enforcement powers were strengthened and a new supervisory engagement model was introduced. The Central Bank (Supervision and Enforcement) Act 2013 provided the regulator with extensive powers to source information, conduct thorough investigation of banks' activities including through on-site inspections, issue regulations, direct remedial actions and credibly enforce compliance by banks including through new criminal offences and fines. In late 2011 the CBI introduced a new risk-based supervision system under which the level of supervisory engagement is proportional to the potential impact of a firm on financial stability and consumers. Hence, high-impact firms are subject to a higher level of supervision under structured engagement plans, leading to early risk-mitigation interventions.

The regulatory regime for credit unions (CUs) was reformed to ensure the long-term sustainability of the sector and protect financial stability. Legislation enacted in 2012 included provisions for the (i) restructuring of the sector through amalgamations and transfers on a time-bound voluntary basis, overseen by a Restructuring Board; and (ii) the stabilisation of viable but undercapitalised CUs, including through financial support. In addition, the legislation provided for enhanced prudential regulation and governance of the sector. The act also created a Credit Union Fund to support the restructuring and stabilisation processes. To protect fiscal resources the legislation stipulated that public funds would be used only after funding from the sector has been exhausted and will be recoupable through a levy over time.

Legislation providing for the establishment of a central credit register (CCR) was enacted in late 2013. The CCR would help improve banks' risk management practices and facilitate prudential supervision through providing comprehensive credit information on new and existing borrowers. Some uncertainty remains about the implementation of the CCR as the authorities have indicated that the section providing for the use of the personal public service number as a unique borrower identifier may not be commenced immediately. Every effort should be made to have the register fully operational at the earliest possible date.

The enhanced provisioning guidelines are an important element of the CBI's reinforced supervisory tool-kit. In December 2011 the CBI issued best-practice guidelines to banks aiming to ensure that their provisioning methodologies reflect more conservative impairment triggers resulting in earlier completion of impairment reviews and recognition of incurred loan losses as early as possible within the scope of existing accounting standards. The guidelines also stated that banks should adopt a sufficiently conservative and comparable approach to the measurement of impairment provisions across loan portfolios and improve the

(Continued on the next page)

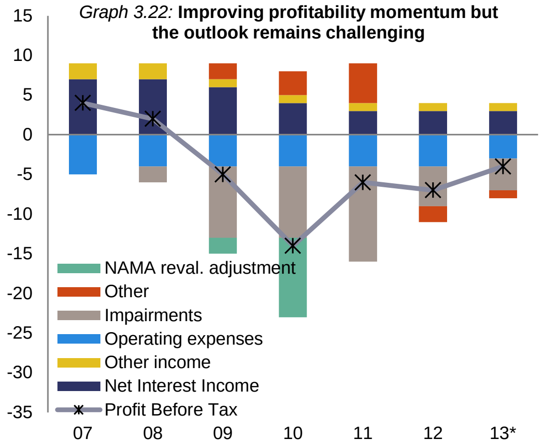
Box (continued)

quality and quantity of their asset quality and credit risk management disclosures. Given the increased scope for loan restructurings as banks step-up arrears resolution, these guidelines were updated in May 2013. The revisions include clarified definitions of non-performing and cured loans, and stipulate more stringent provisioning treatment of forborne exposures.

As a result, banks' funding profiles began normalising, with stable deposits despite falling rates, growing market funding at favourable yields and Eurosystem borrowing back to pre-crisis levels. The regulatory system and prudential supervision were also substantively reformed (Box 3.4). Thus, the programme underpinned financial stability and helped Ireland emerge from a severe banking crisis.

However, financial sector repair is not yet complete and challenges remain. The stock of non-performing loans (NPLs) continues to increase, albeit at a reduced pace, with the average NPL ratio for the three domestic banks at almost 27% - the highest in the EU. In response, banks have increased loan-loss provisions, and are stepping-up efforts to address mortgage and SME loan arrears, with performance against targets monitored by the CBI. While impairment losses have likely peaked as the flow of new arrears slows, and despite positive margin momentum for 2014 (Graph 3.22), Irish banks' profitability is challenged by the structure of their assets in a low-policy rate environment (Box 3.1). Though Ireland's economic recovery is not reliant on lending in the near term, weak bank profitability could present a supply constraint to credit which will be necessary to sustain growth. In the medium term, Irish banks are also exposed to regulatory vulnerabilities as after Basel III ([19]) is fully implemented their common equity tier 1 (CET1) ratios are estimated to be among the lowest in Europe, due to sizeable deductions from capital related to deferred tax assets (DTAs) and preference shares ([20]).

Graph 3.22: **Improving profitability momentum but the outlook remains challenging**



Source: Irish domestically-owned banks' annual reports

Notes: 2013 figures are annualised.

3.3.3. NPL resolution and bank capital

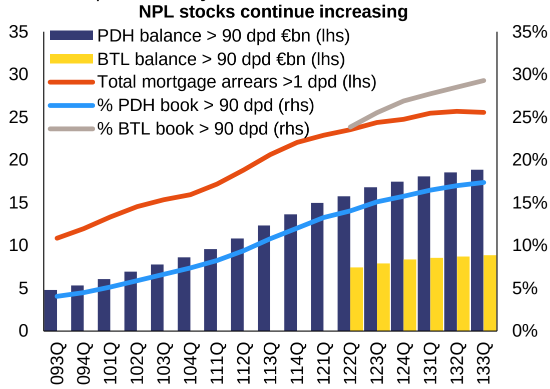
The Irish authorities have established a robust institutional framework enabling banks to tackle the high stock of NPLs. As to residential mortgages, which account for about 50% of domestic banks' NPLs, the CBI has established a three-tier targeting system, which mandates lenders to treat increasing shares of their over 90-day arrears cases through implementing sustainable loan restructurings ([21]). Other regulatory measures addressing distressed mortgages include personal insolvency and bankruptcy reforms, and changes to the repossession regime and consumer protection rules. These have also contributed to increased levels of engagement between debtors and lenders, resulting in more arrears cleared by borrowers and durable loan restructurings. The pace of arrears formation continues to slow and in the third quarter of 2013 total home-loan mortgage arrears declined for the first time since the series began in 2009 (Graph 3.23). Resolution of distressed SME

([19]) The new global standard on bank capital adequacy and liquidity reflecting the Basel III agreement, transposed into the EU legal framework via the Capital Requirements Regulation and Capital Requirements Directive IV, which entered into force on 17 July 2013.

([20]) DTAs are recorded to reflect carry-overs of bank losses if it is deemed likely that they will be used to reduce tax expense in subsequent periods.

([21]) For details of the CBI Mortgage Arrears Resolution Targets see: http://www.centralbank.ie/press-area/press-releases/documents/approach%20to%20mortage%20arrears%20resolution%20-.pdf loans, accounting for over 19% of total impairments, is also monitored against bank key performance indicators and targets though these are not public. More time is likely required for some banks to durably restructure these loans, many of which have links to property.

Graph 3.23: **Early stabilisation in total arrears but NPL stocks continue increasing**



Source: Central Bank of Ireland

Notes: PDH = primary-dwelling home; BTL = buy-to-let property; total mortgage arrears series shows the balance in EUR billion in total PDH arrears (from 1 day past due).

The authorities should set increasingly ambitious bank targets to ensure that the bulk of NPLs are durably restructured during 2014. The targets for agreed mortgage restructurings should reach 100% of arrears cases over 90 days past due, if possible by end-2014. To monitor the durability of modified loans from the first quarter of 2014 the authorities have established an ambitious ([22]) 75% target for continued adherence by debtors to the renegotiated loan terms. Thus, banks need to ensure that agreed solutions are sustainable and compliant with CBI guidelines. A similar level of ambition should apply to SME loan restructures and a strategy should be developed for addressing distressed commercial real estate exposures, a large share of which have SME connections and account for almost 25% of domestic banks' NPLs.

Capital consumption due to NPL resolution is not estimated to result in breaches of regulatory capital thresholds. Domestic banks have increased loan-loss provisions with their average coverage ratio rising by 10 percentage points to 54% from end-2010 to September 2013. The recent CBI balance sheet assessment (BSA) concluded that adjustments in risk-weighted assets and significantly higher provisions are warranted. However, the exercise also found that, on a point-in-time basis at end-June 2013, capital buffers were sufficient for banks' capital ratios to remain above the then CT1 regulatory threshold of 10.5% and the 8% CET1 floor to be used in the ECB comprehensive assessment. However, some uncertainty remains regarding the outcome from the forward-looking stress test element of the comprehensive assessment.

The consumption behaviour of only about 10% of Irish households is estimated to be directly affected by mortgage arrears resolution. CBI research indicates that households in mortgage distress spend 18% less on average as compared to the general household population ([23]). However, in the third quarter of 2013 only about 8% of households were in arrears including below 90 days. In addition, 2% of primary-dwelling home loans that are not in arrears were restructured possibly also indicating cases of borrower distress. Thus, the consumption of a maximum of about 10% of households could be directly affected by the mortgage arrears resolution process ([24]). Arrears formation is also expected to slow further, while durable restructures gradually replace short-term forbearance.

The direct impact of mortgage arrears resolution on consumption is likely to be small. Assuming that the same share of households in debt distress has the same share in consumption, and that re-instating debt service at an affordable level would reduce their expenditure somewhat even in cases where some debt relief has been provided, no growth in consumption for these households could be estimated. Assuming that consumption increases for other households at the same rate as in the last Commission forecast, it is estimated that mortgage arrears resolution, if fully implemented, could reduce consumption by roughly EUR 0.4 billion, or by 0.5% cumulatively

([22]) Data on re-default rates is limited though recent experience from the US and the UK suggests that restructured loans become delinquent in about 30 to 40% of cases in the first 12 months after renegotiation, though this is less prevalent when permanent principal and/or interest reductions are provided. Thus, the CBI target of max. 25% re-default rate in 2014 appears conservative.

([23]) Lydon (2013).

([24]) This calculation reflects arrears *balances* data published by the CBI; the number of arrears *cases* from the same dataset shows just about 6.5% of households being in any arrears (these figures refer to primary-dwelling homes only).

during 2014-2015. Moreover, part of this drag could be offset by some distressed households increasing spending due to receiving some debt relief. Thus, resolving mortgage NPLs is unlikely to have a large direct impact on household consumption.

However, associated confidence effects could be considerable in the medium term and NPL resolution could support banks' capacity to increase productive lending to the economy. As durable loan restructurings are implemented restoring debt service at affordable levels, financial uncertainty will be reduced and the debt sustainability of households reinforced. Perceptions about banks' asset quality should also improve, as would those of property prices after banks work through a possibly sizeable housing inventory, thus underpinning future demand for property. These factors can translate into considerable confidence effects in the medium term. In addition, given the already high asset encumbrance of Irish banks ([25]), their high NPL ratios entail limited available collateral for additional secured market funding ([26]). Thus, as arrears are resolved over time and new credit extension continues thereby improving banks' overall asset quality, their capacity to raise market liquidity would be strengthened, supporting lending to the real economy. Moreover, once arrears resolution nears completion, banks would be gradually able to re-allocate resources and re-focus their operations from arrears management and collections to their core business.

3.3.4. Bank profitability

Restoring profitability is necessary to sustain new lending and return banks to private ownership, and while prospects have recently improved important challenges remain. As funding costs declined and new credit was extended at higher rates, banks' net interest margins (NIM) continued to increase in the second half of 2013. Despite expected higher provisions to reflect updated provisioning guidelines and the recent BSA findings, prospects for some banks to return to profitability in 2014 have improved. In their Interim Management Statements providing a mid-year update on their financial performance Ireland's largest domestic banks, Allied Irish and Bank of Ireland, signalled continued improvements in operating profitability due to positive expansion of NIM and cost management initiatives. This was confirmed by a CBI review of operating profits which indicated that both banks forecast a return to post-provision profitability in 2014, though this is highly sensitive to new lending forecasts. In addition, in an environment of low policy rates Irish banks are particularly challenged due to the large share of tracker mortgages in their balance sheets (Box 3.1).

Market-based options to reduce the drag from trackers on bank profitability could be explored. As demonstrated by the continued tightening in market spreads for covered bonds collateralised by Irish mortgages ([27]), secured market issuance involving trackers could soon be priced at funding costs eliminating their negative carry. However, liquidity advancement rates using these securities would likely still be punitive for banks given market collateralisation requirements ([28]). In addition, such issuance could only be placed in the market if there are no delinquent assets in the collateral pools, and recent analysis by the authorities has confirmed that in order to offer meaningful benefits to banks, any solution should also include non-performing trackers.

([25]) According to the ESRB's "Annex to the recommendation on funding of credit institutions", Irish banks' total asset encumbrance (pledged loans/total loans) at end-2011 was 30%, while mortgage-loan encumbrance exceeded 55%.

([26]) High asset-encumbrance also constrains the capacity of banks to issue unsecured debt, as investors in such securities are subordinated to secured creditors (which have recourse to the balance sheet of the issuer as well as to the pledged asset collateral).

([27]) Asset-swap spreads (versus 6-month euribor) on all outstanding AIB and BOI asset-covered securities (ACS) were trading in the 80-115 basis points range at the time of writing this report.

([28]) Net liquidity advancement reflects the funding provided after a discount is applied on the market value of collateral.

Table 3.1:
SME credit policy initiatives

Policy measure	Date	Additional credit volume	Jobs protected/created
Credit Review Office (CRO), set up to mediate on disputes between lenders and prospective SME borrowers who have been refused credit.	Dec 2009	€21mn overturned as of end-Oct 2013	about 1,700
Microfinance Ireland extending loans between €2,000 and €25,000 to firms with less than 10 employees	Q3 2012	€90mn (over 10 year horizon); €4mn to date	263
Temporary Loan Guarantee Scheme for firms with specific characteristics that are unable to access bank financing.	Q4 2012	€150mn in guarantees available per year over 3 years; about €10mn to date	about 500
Provision of finance via NPRF to SMEs through partnership with private sector investors, comprising one credit fund (Bluebay Mid Market Fund - €200mn NPRF commitment; €450mn total fund size) and two equity funds (Carlyle SME Restructuring and Growth Fund - €125mn from NPRF, €350mn total; and Better Capital SME Turnaround Fund - €50mn from NPRF, €100mn total).	Q1 2013	€450mn credit and €450mn equity; strong transaction pipeline, 2 deals for combined amount of €41.5mn signed to date	100

Possible national solutions could involve credit enhancement using high-quality uncorrelated assets. These could be repoed in the market to source liquidity at lower funding cost and better advancement rates, which could then be on-lent to the banks against new own-use bonds secured on tracker portfolios ([29]). However, a number of challenges to such an approach including applicable state aid rules would need to be explored further.

3.3.5. Access to finance

Lending to Irish enterprises remains weak, though this is more likely driven by subdued credit demand than supply constraints. Bank credit to resident NFCs and SMEs decreased by 3.9% and 4.8% yoy, respectively, at end-September 2013. Nonetheless, survey evidence suggests that an increasing number of SME loan applications are being approved in full by banks and the success rate in obtaining financing for Irish firms is trending to the euro-area average ([30]). Despite strongly improved trading performance, Irish SMEs' demand for credit reportedly declined by 36% during the six months to September 2013. Factors behind this could include tight credit conditions reflecting efforts by Irish banks to improve profitability, or a perception by firms that banks are not lending. However, latest survey evidence suggests that gradual demand substitution may be ongoing: improved trading performance has contributed to a lower overall level of demand as funding requirements for working capital from weaker firms declined. This has so far not been offset by higher demand for investment and growth as SMEs remain cautious about future trading performance.

Improving access to finance includes more non-bank financing options. Although the amount of bank financing has decreased, due to constraints on both the demand and the supply side, Irish companies, and SMEs in particular, remain highly exposed to the bank sector and its vulnerabilities: more so than their average EU counterparts ([31]). Thus, there is room for the development of the Irish equity and debt financing providers that could help SMEs diversify their risk. However, technical capacity within many Irish small firms may be limited, which would explain the low take-up of more complex non-bank funding schemes so far.

State-backed funding initiatives are supporting SME credit and employment, though additional effort is needed to increase take-up. Schemes established during the programme included direct government funding, private debt and equity financing with state participation, loan guarantees and credit mediation. These have witnessed some modest initial successes in generating extra credit and helping create and protect jobs in the sector

([29]) Own-use bonds are securities issued by a bank to itself and backed by asset pools (e.g., tracker mortgages).
([30]) For more details see the latest RedC and ECB SAFE surveys covering the period April-September 2013.

([31]) Lawless et al. (2013).

(Table 3.1), though take-up so far has been low and needs to be increased. A new programme to help build technical capacity in SMEs should support the development of skills necessary to use more complex funding schemes available. Nonetheless, repairing the bank credit channel will be important to improve access to finance more appreciably. A comprehensive strategy for SMEs should be developed to address both funding and debt restructuring issues, and to implement the recommendations of the High Level Expert Group on SME and Infrastructure Finance published in December 2013.

Lending, particularly to enterprises, is necessary for sustained economic growth. Research has highlighted that at high levels of financial development, as measured by the ratio of private sector credit to GDP, the relationship between financial development and economic growth becomes negative. This could be partly explained by the large share of lending extended to households, which evidence suggests has an insignificant effect on GDP growth ([32]). A study has found that the level of private sector credit in Ireland is higher than the level predicted by a range of socio-economic factors ([33]). This may suggest that limited future growth could be derived in Ireland through financial intermediation. Economic growth in Ireland in the near term is not reliant on new lending, as output is forecast to be largely driven by net exports in 2014-15 and employment gains boost consumption. Nonetheless, other research identifies a positive and significant relationship between enterprise credit and GDP per capita growth, also implying that the source of that funding does not matter. ([34]) Hence, enterprise credit initiatives in Ireland should be pursued via both bank and alternative finance sources.

3.3.6. The non-bank financial sector

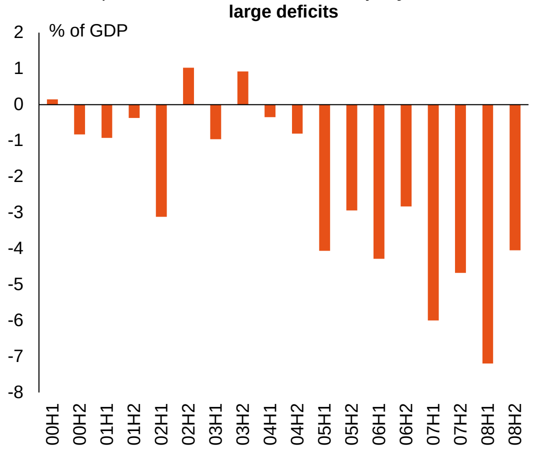
The asset management industry could contribute to the growth of the financial sector, provided that it is adequately supervised ([35]). Recent analytical work by the CBI discusses a potential relaxation of loan origination prohibition rules to the asset management sector ([36]). The work nevertheless also highlights the contagion risk that investment funds may transmit to the traditional banking system under some circumstances. Still, the potential impact of this sector to Ireland's overall macroeconomic stability is limited as it is not integrated into the domestic economy and the assets under management are foreign-owned.

3.4. COMPETITIVENESS AND SUSTAINABILITY OF THE EXTERNAL POSITION

3.4.1. Imbalances build up fast at the peak of the boom

Ireland's external accounts deteriorated sharply and rapidly during the property bubble. The current account had remained in surplus or close to balance during the Celtic Tiger years, and it is not until 2004 that Ireland's current account tuned into a large deficit. The construction boom fuelled by large financial inflows from abroad induced a reallocation of resources towards the non-tradable sector and a surge in imports. Between 2004 and 2005, the current account deficit rose 3 percentage points to 3.5% of GDP, before further rising to around 5.5% of GDP in 2007 and 2008.

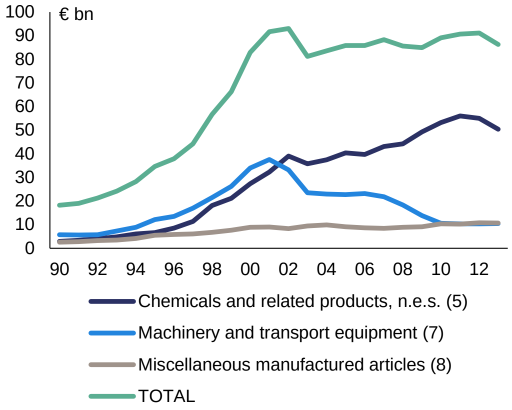
Graph 3.24: **The current account rapidly turns into large deficits**



Source: CSO

([32]) Arcand et al. (2012) and Beck et al. (2012).
([33]) Beck (2014).
([34]) Ibid.
([35]) From EUR 330 billion at the end of 2008 toEUR1,068 billion at the end of November 2013, the assets under management of Irish domiciled investment funds have almost tripled in size, according to the CBI and ECB.
([36]) CBI (2013).

Graph 3.25: **Goods exports experience structural changes**



Source: CSO

Global trends in manufacturing negatively affected Ireland's exports already in the early 2000s. Foreign computer manufacturers like Gateway and Dell started closing plants in Ireland in 2001 as manufacturing centres were delocalised to cheaper production locations in Asia, to such an extent that exports of office machines and automatic processing equipment collapsed back to their 1990 levels by 2010. In contrast, the pharma-chemical sector, also led by FDI from global companies, continued to develop throughout the 1990s and 2000s to the point where exports of pharmaceuticals represented close to 60% of total goods exports in 2013. The pharmaceutical sector is also subject, however, to rapidly shifting patterns in global production, including the emergence of low-cost production centres in countries like China, India or even Bangladesh and the rising importance of generics.

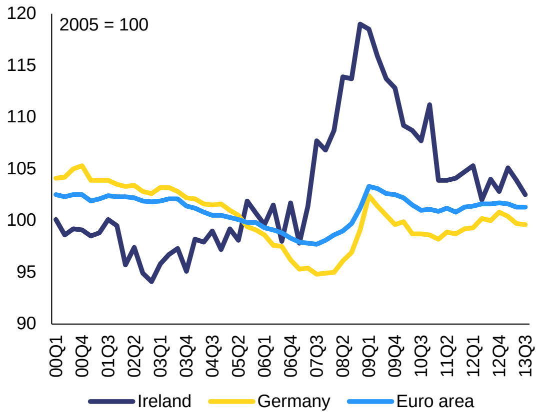
Ireland's share in world goods exports halved to 0.64% from the early 2000s to 2012. Merchandise exports were broadly at their pre-crisis level in 2013 as rising exports of pharmaceuticals just about compensated for vanishing computer exports. Overall, Ireland nevertheless remains a very open economy, with total merchandise trade representing around 80% of GDP, similar to the EU average.

Ireland's decline in relative terms as a global manufacturing centre was most likely inevitable. As they are driven by FDI flows and foreign multinationals, Ireland's exports are particularly susceptible to changes in global patterns of product specialisation and shifts in the structure of value chains.

Rising unit labour costs nevertheless accelerated an ongoing phenomenon. Real unit labour costs tended to decline in line with developments in the euro area in the first few years of the 2000s, but went on a gradual rising trend from 2003 onwards before surging around 2007. In turn, the real effective exchange rate (REER) evolved alongside that of the euro-area as a whole until around 2005, a period during which structural reforms in Germany induced productivity gains and wage restraint. Higher inflation and wage growth thereafter decoupled Ireland's REER developments from those in the core of the euro-area and Germany in particular.

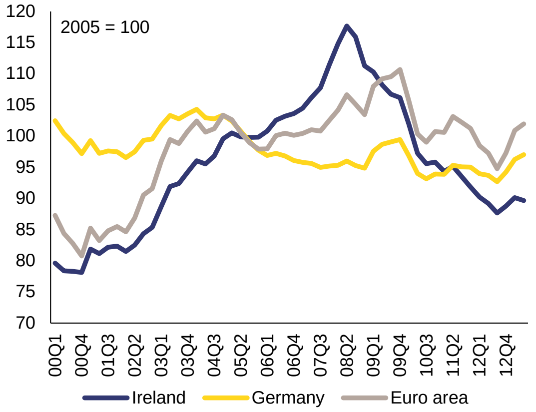
More than many other countries, Ireland was vulnerable to losses of competitiveness. Given the sheer contribution of the FDI sector and multinationals in exports, GDP and employment, Ireland's economy is very reactive to losses of competitiveness through wage and/or productivity developments that are out of line with those in the euro-area and beyond. It is also vulnerable to developments that affect the locational choice of major multinationals, including in terms of corporate taxation, the business climate in general, the quality and cost of infrastructure services and the availability of skills (see also section 3.5).

Graph 3.26: **Real unit labour costs surged in the mid-2000s)**



Source: Eurostat

Graph 3.27: **The REER appreciated through most of the first part of the 2000s**

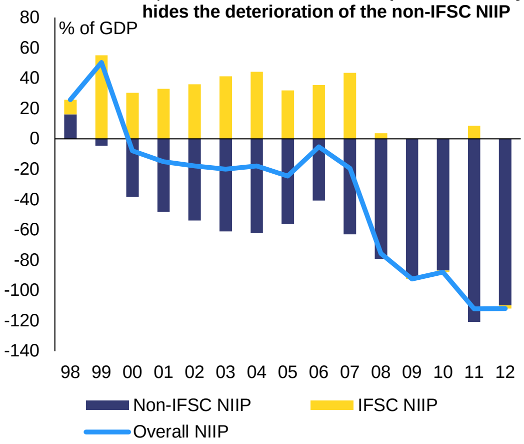


Source: Eurostat

Private financial flows comfortably covered the rising current account deficit. As the current account deficit widened, much of the financing came in the form of bonds, money market instruments, loans and deposits. To a significant extent, these flows were intermediated by Irish domestic banks whose loan to deposit ratios surged. In contrast, and reflecting structural shifts in the economy, net FDI flows turned sharply negative.

Ireland's net international investment position (NIIP) nevertheless took time to deteriorate. Rising current account deficits did not at first translate into an increase in Ireland's negative NIIP. By 2007, the negative NIIP represented about 20% of GDP, around its level for most of the 2000s. Ireland's NIIP is somewhat unusual, however, in that it is affected by the uncommonly large size of the FDI sector and by the flows generated by the International Financial Services Centre (IFSC). ([37]) During the early 2000s, rising equity injections, reinvested earnings, intra-company loans and external borrowing by the affiliates of multinational companies followed by rising bond issuances by domestic banks led to an increase in the negative NIIP excluding the IFSC from minus 4.6% of GDP in 1999 to minus 63% in 2007. Overall, this deteriorating trend was hidden by the large positive net position generated by the IFSC, but pressures were mounting already.

Graph 3.28: **IFSC's net creditor position initially hides the deterioration of the non-IFSC NIIP**



Source: CSO

3.4.2. The crisis and rebalancing

The burst of the real-estate bubble led to a rapid and sharp adjustment in the current account. The collapse of the economy was at first driven primarily by plummeting investment and a steep drop in private consumption, followed somewhat later by a significant contraction in public expenditure. The contraction in domestic demand and the rapidly drying up of sources of external financing forced the current account deficit to contract from EUR 10.1 billion in 2008 to EUR 3.8 billion in 2009 and to swing into a surplus of EUR 1.8 billion in 2010. The structure of Ireland's economy, its large export-orientation and its ability to run significant current account surpluses prior to the excesses of the real-estate bubble made such a rapid correction possible.

The rebalancing process has been rapid and effective. The onset of the crisis has in part forced the rebalancing from the non-tradable to the tradable sector upon the Irish economy through a destructive process, i.e. the collapse of domestic demand and the loss of employment and output in the non-tradable economy, particularly but not exclusively the inflated construction sector. This "destructive adjustment", however, has also been

([37]) The FDI sector also has an impact on the current account through income flows that is both extremely large and at times difficult to disentangle precisely. Ireland has attracted not only large foreign companies with a genuine commercial presence in the country, but also a number of companies that have established small headquarter operations that channel disproportionately large income streams for tax purposes. These operations have not only impacted the current account and the NIIP, but also the measurement GNP. Fitzgerald (2013) estimates that the so-called re-domiciled Plcs may have inflated the current account surplus by around 5% of GDP in 2012.

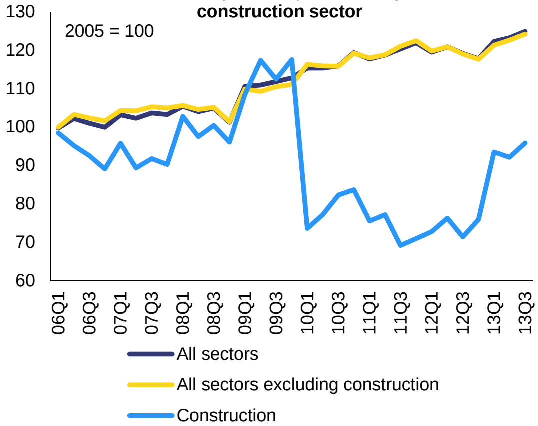
met by a "constructive" process that has enabled Ireland to regain the competitiveness it lost during the 2000s and to grow its tradable sectors.

Improvements in competitiveness have been significant. Over the past few years and in the context of the EU-IMF programme of financial assistance, Ireland has stepped up its efforts to rein in labour costs in the public and private sectors (see section 3.5), increase labour productivity and improve cost and non-cost competitiveness.

Significant productivity gains have been achieved in the past few years. Whether measured by real labour productivity per hour worked or by real gross valued-added per hour worked, gains appear to have been not only sizeable, but also larger than in the euro-area as a whole or in Germany. Composition effects resulting from the loss of construction output (with traditionally low productivity) appear to account for relatively little of the overall productivity gains. This is not particularly surprising given that productivity gains have been sustained for several years even though construction output came to a virtual halt in a matter of months and now represents a very small fraction of total output. Shifting patterns in the composition of manufacturing output and in the structure of overall output do influence, however, overall measures of productivity and competitiveness. The rising weight of high-productivity sectors such as the pharmaceutical industry means that productivity gains for the economy as a whole are likely somewhat overstated by aggregate indicators ([38]).

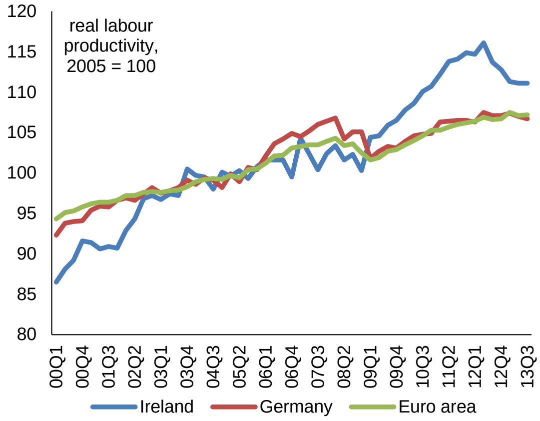
([38]) O'Brien (2011).

Graph 3.29: **Real gross-value added per hour worked rises independently of the collpase of the construction sector**



Source: Eurostat

Graph 3.30: **Recent productivity gains have exceeded those in the euro-area**

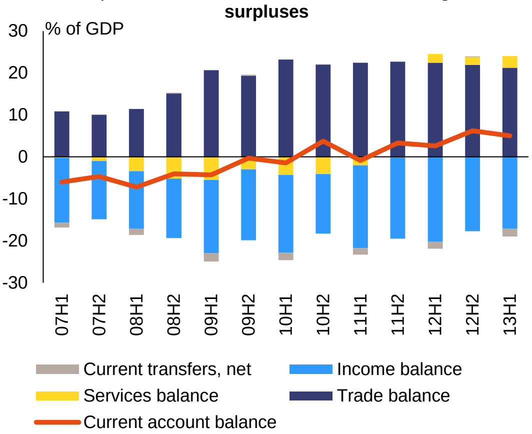


Source: Eurostat

The correction in the real effective exchange rate (REER) has preceded that in other euro-area Member States and also been sharper. While the appreciation of the REER in the first part of the 2000s was higher in Ireland that elsewhere in the euro-area, the depreciation over the past five years has also been more significant. Using 2005 as the base year, the REER index has again fallen below that of Germany and the euro-area as a whole, with a cumulative depreciation of about 25% from peak (Q2 2008) to trough (Q2 2013).

The current account has swung to a large surplus. The rebalancing over the past few years has been such that the current account shifted from a deficit of 5.6% of GDP in 2008 to a surplus of 4.4% in 2012, which is expected to have risen further to 7.0% in 2013. The trade surplus increased over the past few years despite the broadly stable level of exports, which indicates that local value addition has also been on the rise. This rising trend appears to be tapering off, however. The second largest driver of adjustment in the current account has been the balance on services, which turned into surplus for the first time in 2012 at EUR 3.2 billion, in sharp contrast with deficits in excess of EUR 10 billion in the first half of the 2000s. The services surplus further increased to EUR 4.4 billion in the first nine months of 2013, highlighting a further structural change in Ireland's economy and its position vis-à-vis foreign investors.

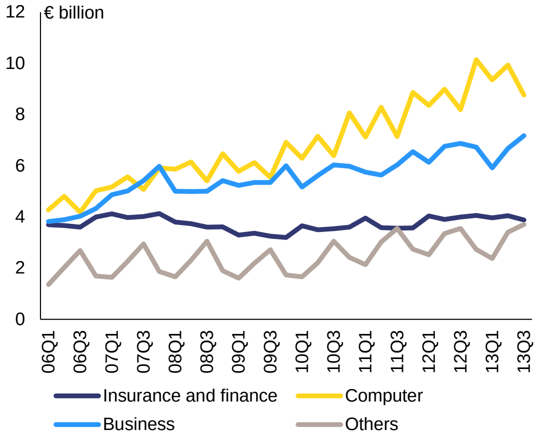
Graph 3.31: **The current account turns to large surpluses**



Source: CSO

Ireland's trade is shifting towards services. As it consistently lost export market shares on the merchandise side with the delocalisation wave in the computer industry, Ireland also developed as a services hub for multinationals, including software and other ICT sectors and business services. In the first three quarters of 2013, computer services represented 41% of services exports, with another 39% accounted for by business services and 17% by insurance and finance.

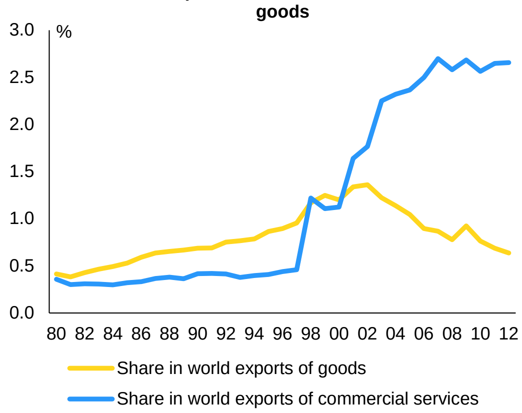
Graph 3.32: **Services exports increase sharply**



Source: CSO

Ireland's market shares in services exports have surged. Similarly to what happened with goods exports in the 1990s, the development of Ireland as a services hub has been led by the investment decisions of major multinational companies. Net inflows of FDI have become large again since 2010 and are now directed mostly to the services industry. Although global trade in commercial services represented only about a quarter of global merchandise trade in 2012, it has also tended to increase somewhat faster on average since the 1980s. Ireland's share of this growing global market, in turn, increased more than six-fold from 0.41% in the first half of the 1990s to 2.66% in 2012.

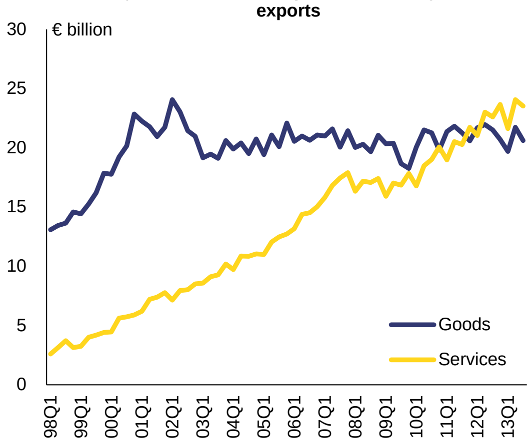
Graph 3.33: **Ireland gains significant global market shares in exports of services, but loses them in goods**



Source: WTO

Services exports have surpassed goods exports and have been resilient through most of the crisis. The increase in services exports has been such that they overtook merchandise exports in Q4 2011 and have been higher ever since. In addition, they have been quite resilient through the Irish and global crisis as they only experienced a short-lived stagnation in 2008 and 2009 before resuming their rising trend.

Graph 3.34: **Services exports overtake goods exports**

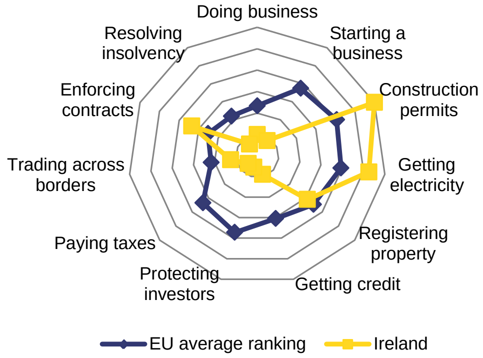


Source: CSO

Ireland's regained cost competitiveness and structural rebalancing have been supported by the general strength of its business environment. The attractive and investor-friendly nature of Ireland's investment climate has underpinned its ability to attract large FDI inflows during the past decades. It is recognised by a number of public and private institutions, including the Commission itself, the OECD, the World Bank or the World Economic Forum. ([39]) Under the World Bank's *Doing Business Indicators 2014*, Ireland ranked better than the EU-average for all but three categories, and it placed among the top countries in the world for six of them.

([39]) See for example the European Commission's Member States' Competitiveness and Industrial Performance Scoreboard 2013.

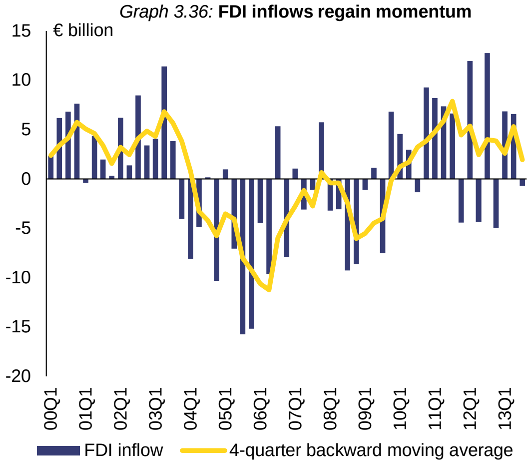
Graph 3.35: **Ireland ranks highly in business climate indicators**



Source: World Bank, Doing Business

Renewed momentum in FDI inflows reflect regained competitiveness and reinforce the rebalancing of the economy. Net inflows of FDI decelerated well before the onset of the crisis and turned negative for several years before turning positive again in 2010. The momentum has been maintained since then and the pipeline of projects announced by the Industrial Development Agency (IDA), which is in charge of promoting Ireland as an investment destination, attests to the renewed level of confidence by the international business sector in Ireland's potential as a regional or global hub. New projects and additional investments by existing affiliates are also set to further contribute to the rebalancing of the economy and the expansion of the tradable sector.

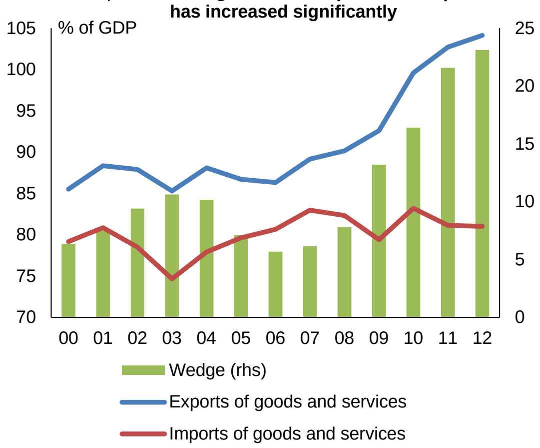
Graph 3.36: **FDI inflows regain momentum**



Source: CSO

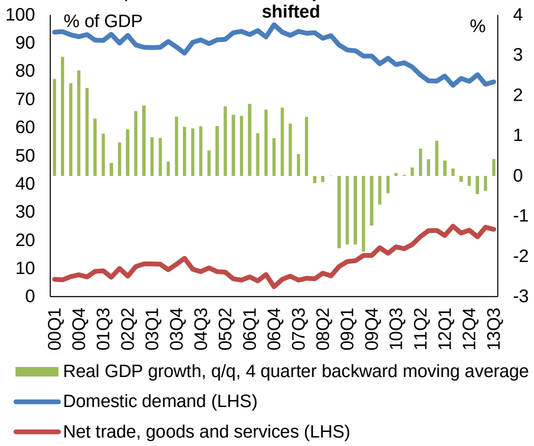
The demand composition of GDP has significantly shifted over the past few years as the economy rebalanced. The reallocation of resources towards the tradable sector and the "destructive adjustment" are further evidenced by the large shift in the relative contributions of domestic demand and net exports of goods and services in total output. Although Ireland has been a very open economy for decades, the adjustment of the past few years has boosted the share of net exports in GDP to around 23%, double the level previously sustained in the early 2000s. This has been achieved as the share of imports of goods and services in GDP remained constant while the share of exports of goods and services rose markedly, which is indicative of the rising value added and lower import intensity of exports. It must be noted also that, even though there has been a significant degree of "destructive adjustment", domestic demand has now stabilised and is expected to rise in 2014.

Graph 3.37: **Wedge between exports and imports has increased significantly**



Source: CSO

Graph 3.38: **Demand composition of GDP has shifted**



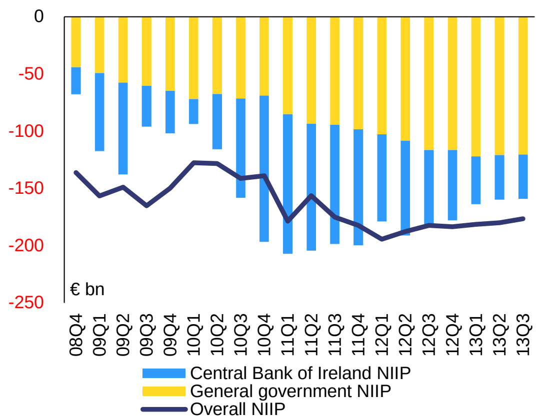
Source: CSO

Ireland has accumulated a large negative NIIP as a result of the crisis. As indicated earlier, it is important to distinguish between the IFSC NIIP and the non-IFSC NIIP in order to disentangle the underlying drivers and potential imbalances. While the IFSC had a net creditor position of 43% of GDP at the end of 2007, it dropped to near-balance by end-2008, including as a result of large (negative) valuation changes, and has remained there since then. Gross credit and debit positions do remain very large, however, at around 14 times GDP, which means that the net position could easily swing back to significant credit or debit, including through valuation effects as a large proportion of these positions are held in the form of equity.

The bailout of domestic banks has driven the deterioration of the NIIP. In stark contrast with the balanced IFSC NIIP, the non-IFSC NIIP deteriorated sharply over the past few years from a net debit position of 63% of GDP at the end of 2007 to 104% of estimated GDP in September 2013. The negative position peaked at EUR 196 billion at the end of 2011 but fell since to EUR 172 billion at end-September 2013. The operations linked to the government bailout of domestic banks and the credit flows under the EU-IMF programme of financial assistance that ensued have been the driver of Ireland's deteriorating NIIP. The provision of emergency liquidity assistance (ELA) by the Central Bank of Ireland, the issuance of promissory notes and their subsequent conversion into long-term bonds, and the EUR 67.5 billion package of financial assistance from the EU, IMF and bilateral creditors have all impacted the NIIP over the past few years in significant ways.

The nature of the authorities' net debit position has shifted in recent quarters. In the initial stages of the banking crisis, the Central Bank of Ireland (CBI) accumulated the bulk of the authorities' negative NIIP as it provided funds under the ELA. At its peak in Q4 2012, prior to the granting of financial assistance from the EU and IMF, the Central Bank had accumulated a negative NIIP of EUR 128 billion. The CBI's position has been gradually unwound over the past few quarters, including as a result of the conversion of promissory notes into long-term government bonds. The general government's negative NIIP, however, has concurrently increased as funds were disbursed under the EU-IMF programme of financial assistance.

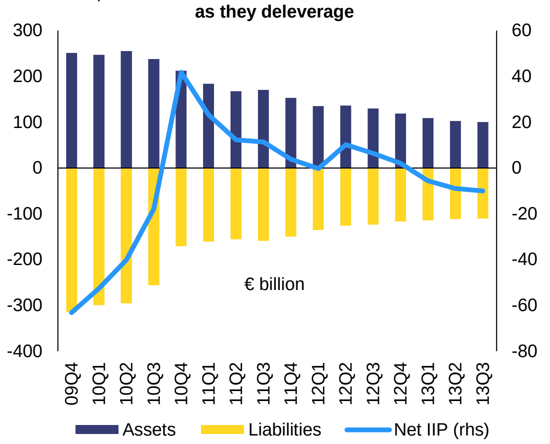
Graph 3.39: **The official sector drives the deterioration of the NIIP**



Source: CSO

The NIIP of domestic banks reflects the transfer of liabilities to the public sector and the impact of the programme. The downsizing and deleveraging imposed on domestic banks as part of the crisis resolution strategy and the EU-IMF programme of financial assistance has had a significant effect on their own NIIP. The foreign liabilities of domestic banks were divided by a factor of almost three between end-2009 and September 2013. Their foreign assets, in turn, were reduced by a factor of 2.5 in the same period as ownership of large segments of the banks' balance sheets were transferred to the National Asset Management Agency (NAMA), bringing the NIIP close to balance ([40]).

Graph 3.40: **The NIIP of domestic banks balances as they deleverage**

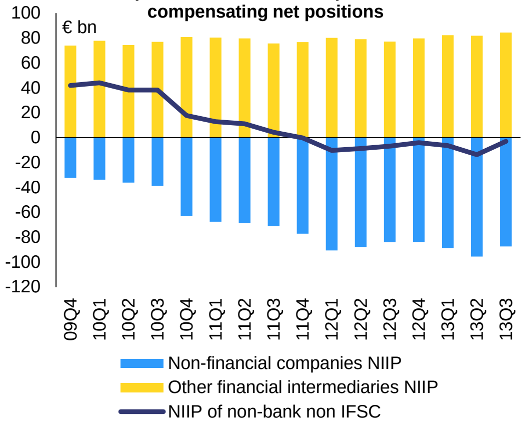


Source: CSO

The FDI sector also has a large impact on Ireland's IIP. Affiliates of large multinational companies tend to finance their investments through direct equity injections, intra-company loans or borrowing outside the Irish banking system and reinvested /retained earnings have also been large. As a result, the FDI sector has traditionally generated a sizeable negative NIIP. As of September 2013, the negative NIIP of non-financial companies represented EUR 87 billion, or 53% of estimated GDP. The effect of this position on Ireland's overall NIIP has been compensated, however, by a positive NIIP of EUR 70 billion from non-bank financial intermediaries, which includes NAMA. Although much smaller than the IFSC's gross positions, valuation changes in the positions of non-financial companies and non-bank financial intermediaries can also have a sizeable effect on Ireland's overall NIIP. Similarly, decisions on earnings retention or repatriation have a potentially significant impact.

([40]) This transfer of assets to NAMA is reflected in the build-up of external assets of "other financial intermediaries", not in the external position of the general government.

Graph 3.41: **Non-bank financial companies (non-IFSC) and non-financial companies have compensating net positions**



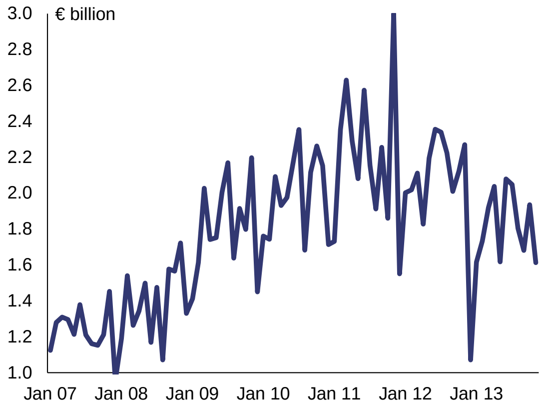
Source: CSO

Issues around Ireland's large negative NIIP are mostly of a public debt sustainability nature. As evidenced above, the scale of the IFSC and the FDI sector are such that Ireland's NIIP can swing relatively quickly and widely. The negative net position that has been accumulated over the past few years, however, is driven by the NIIP of the CBI and general government, as the other parts have broadly balanced. While the high negative NIIP is a source of concern in principle, its roots are well understood, as is the policy response needed to unwind it. Ultimately, Ireland's negative NIIP as it currently stands is a matter of public sector debt sustainability (see Section 3.2) rather than the reflection of large imbalances in the current account sustained over a prolonged period of time.

The nature of the Government's external debt significantly reduces concerns about the NIIP. The general government's negative NIIP position is expected to unwind over a prolonged period as the debt level is reduced in line with the fiscal plans. Also, the long maturities and the relatively low average interest rate on the public debt reduce the servicing burden and refinancing risks (see section 3.2).

The economy and tradable sectors remain dominated by the FDI sector. The bulk of Ireland's exports of goods and services alike are accounted for by large multinational corporations using Ireland as one component in their global value chains. As happened in the 1990s with the computer hardware industry, Ireland is therefore directly affected by global shifts in trade patterns and the organisation of value chains. Its cost and non-cost competiveness, benchmarked globally, is therefore also more crucial than for other EU economies. In this context, developments in the pharmaceutical sector will have a major impact on Ireland's external accounts, including on a net basis. Exports fell in 2013 as a result of the patent cliff. The extent to which this will affect the industry's medium-term potential in Ireland remains unclear; even though indications are that the sector remains vibrant with new projects taking over plant closures.

Graph 3.42: **Pharmaceutical exports are affected by the patent cliff**

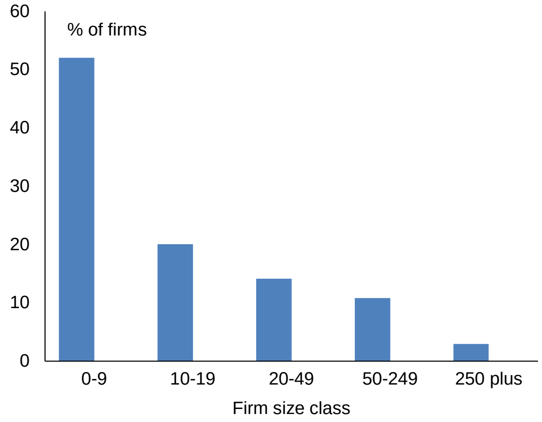


Source: CSO

FDI is relatively concentrated. While it has attracted large inflows of FDI over the past decades, foreign investments in Ireland are relatively concentrated both in terms of investor base and in terms of sectoral orientation. This implies that decisions by individual firms and developments in specific sectors can have an unusually large impact on the economy as a whole.

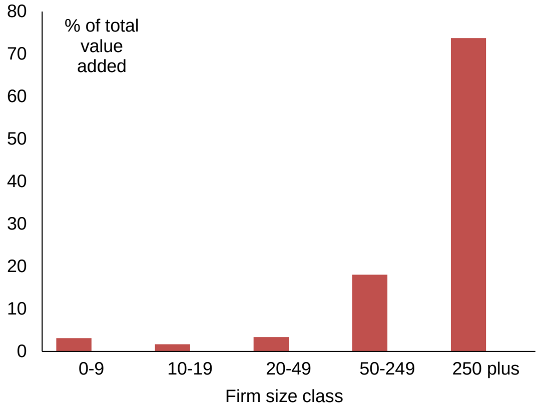
Domestic companies are little internationalised. Ireland's home-grown industrial fabric is dominated by micro, small and medium enterprises, only a small proportion of which are export-oriented and an even smaller proportion of which have the potential to grow into large internationalised groups. This further increases Ireland's reliance on the multinational corporations for exports, the development of high-valued and productivity sectors and (high-skill) job creation.

Graph 3.43: **Most home-grown manufacturing firms are very small**



Source: Eurostat, Commission calculations

Graph 3.44: **Manufacturing value-added is concentrated in large firms**



Source: Eurostat, Commission calculations

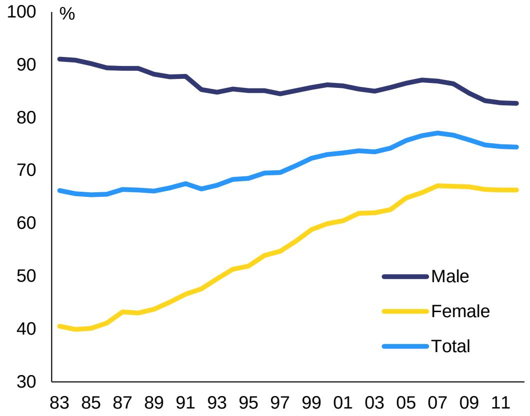
3.5. LABOUR MARKET ISSUES AND SKILLS MISMATCHES

The boom and bust cycle had a deep impact on the Irish labour market and triggered a sharp rise in unemployment. The precise extent to which the increase in unemployment and the deterioration of labour market indicators are cyclical or structural is uncertain at this stage. The government has already implemented several policies to address high unemployment (Box 3.5). The boom and bust cycle has nevertheless generated challenges that require decisive policy actions to support the sectoral re-allocation of the labour force in line with the rebalancing of the economy.

3.5.1. Boom times, imbalances build up

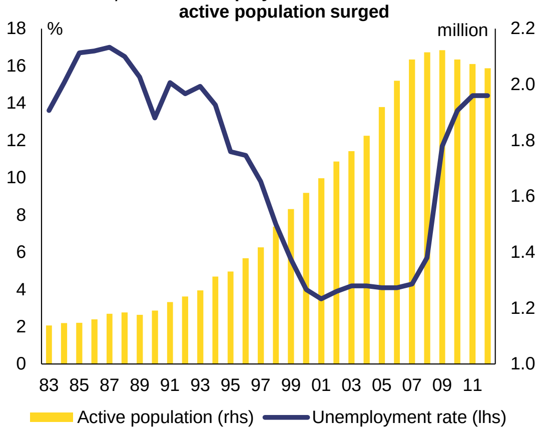
Pre-crisis Ireland displayed impressive labour market indicators, but imbalances were building up already. Ireland experienced full employment for almost a decade. As the active population continued to increase quickly during most of the 2000s and migration inflows accelerated, sustained economic growth generated the level of job creation needed to maintain the unemployment rate at around 4%.

Graph 3.45: **Participation in the labour force rose sharply, particularly among women**



Source: Eurostat

Graph 3.46: **Unemployment remained low while active population surged**



Source: Eurostat

Box 3.5: Policies reforming the labour market

Labour market reforms, job creation and re-skilling have been a centrepiece of Government policy. Five main strands of reforms have been put in place: (1) establishing a modern system of labour market activation; (2) fostering job creation; (3) further enhancing labour market flexibility and enabling wage adjustment; (4) reviewing entitlements to avoid unemployment or inactivity traps; and (5) improving the structures to facilitate re-skilling and up-skilling of the labour force.

Activation policies have been fundamentally reshaped under the *Pathways to Work* strategy. *Intreo* offices have been established to deliver one-stop-shop services to jobseekers (claims for benefits and support services). The establishment of *Intreo* offices was slow at first but many were opened in early 2014 to bring the total to 44, out of an overall target of 63 by end-2014. *Pathways to Work* seeks to fundamentally reshape the services provided to the unemployed, with a focus on regular engagement with case workers, better training opportunities, stronger incentives to take up job opportunities and clearer rights and obligations. The capacity to deliver services remains inadequate as it is constrained by the small number of trained case-workers. In response, the authorities will contract out the provision of support services for around 100,000 jobseekers, all of which long-term unemployed. A request for tenders was issued at the end of 2013, but it will be take until late 2014 until private providers start delivering services.

The government has established a coordinated effort to foster job creation. The first *Action Plan for Jobs* was launched in 2012 and has now become an annual process. It aims to coordinate job-creation initiatives across Departments and operates under a quarterly monitoring system. Stakeholders have become increasingly involved in the preparation of the plan and the monitoring of its implementation.

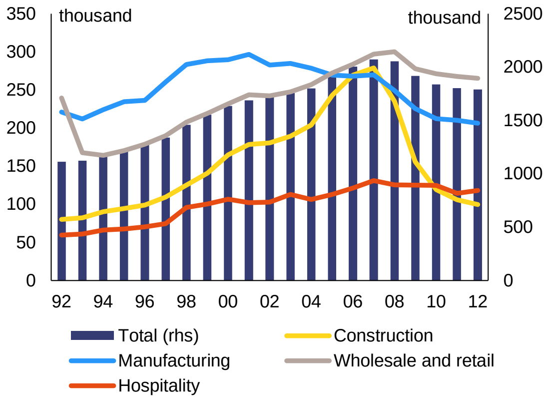
Employment conditions in the public sector have been reviewed. Public service wages were cut on average by about 14% over 2009 and 2010 and the Croke Park agreement introduced: (1) a less generous pension scheme for new recruits; (2) increased room for flexibility, mobility and redeployments; and (3) an increase in working time in certain sectors. Further measures were adopted in 2013 under the Haddington Road agreement, which covers the period 2013-2016. Among others, the agreement further raises working hours, cuts salaries on incomes above EUR 65,000 per annum and introduces additional flexibility measures.

Entitlements have been partly reformed. The entitlement period for JB has been reduced by three months and the benefits are now linked to previous earnings. These changes are unlikely to have a major impact on incentives for the existing pool of unemployed as replacement rates under JB are typically low, except for low-income earners. JA was reduced in 2014, but only for claimants under the age of 26. This reform is therefore unlikely to have a significant effect on the incentive structure for the long-term unemployed. In contrast, payments can now be suspended for up to 9 weeks or reduced under certain circumstances, including refusal to take up a suitable job offer or to participate in the activation process. Rent supplement was reformed in 2014 but it continues to extinguish upon regaining employment, thereby increasing the effective tax rate for a transition back to employment and creating pockets of unemployment traps.

The further education and training (FET) system is slowly being reformed. The government has recognised the necessity to reform the FET system and the delivery of re-skilling and up-skilling opportunities for the unemployed in accordance with the current and prospective needs of the economy. The Education and Training Boards Act 2013 and the Further Education and Training Act 2013 established a new set-up under which the public provision of FET will be guided by and funded through a new body (SOLAS). The new system will revolve around a network of 16 Education and Training Boards (ETBs) that will consolidate a vocational educational centres and FÁS training centres. The success of the reform will hinge upon SOLAS' ability to put in place a credible strategy (to be delivered by end-March 2014) for the sector and make use of its powers to allocate funds among ETBs so as to ensure the efficiency and relevance of programmes. It will also require that a seamless process between *Intreo* offices and ETBs be established to ensure appropriate referrals of jobseekers to training programmes and effective participation.

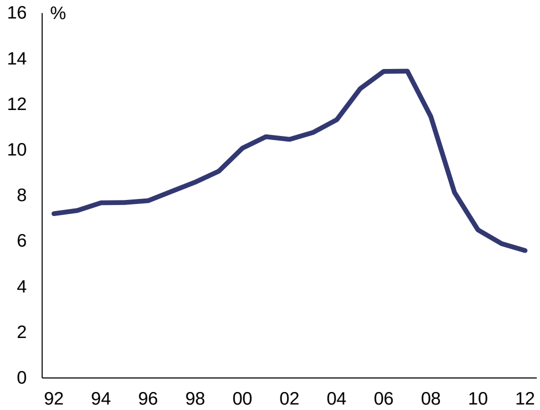
Employment growth was initially widespread across sectors, but increasingly hinged upon the construction and public sectors over time. While overall job creation continued at a fast pace, employment in some important sectors from a labour market perspective broadly stabilised or initiated a declining trend as early as in 2001. In contrast, employment growth in construction gathered further steam to the point of representing 13.5% of total employment by 2007. Similarly, employment in the public sector (including education and health) increased rapidly on the back of the rise in construction-related government revenue.

Graph 3.47: **Employment rose across all sectors, with a sharp increase in construction**



Source: Eurostat

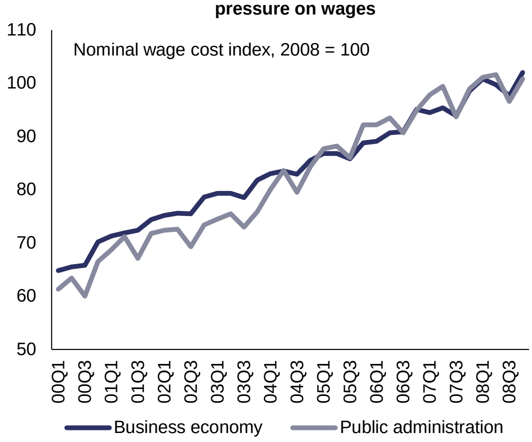
Graph 3.48: **The share of construction in employment rose to unprecedented levels**



Source: Eurostat

Prolonged tight labour market conditions induced strong pressures on wages. With unemployment down to frictional levels and Ireland in the midst of a catch-up process with the frontier, wage growth was high through most of the 2000s.

Graph 3.49: **Tight labour market conditions put pressure on wages**



Source: Eurostat

3.5.2. The crisis and rebalancing

The burst of the real estate bubble and the ensuing broad-based crisis brought a dramatic reversal in the labour market situation and revealed severe imbalances. The reversal of fortunes was stark and abrupt as the unemployment rate more than doubled in just one year to 10% in early 2009, followed by further increases to nearly 15% in late-2011 and early-2012. The construction sector bore the brunt of the adjustment, with employment falling to barely a third of its peak level by late-2012 and close to 200,000 jobs being shed in a very short time span ([41]). By the time the adjustment had run its course, employment in construction represented only about 5% of the total from a peak of nearly 14% in 2006, despite the concurrent fall in overall employment.

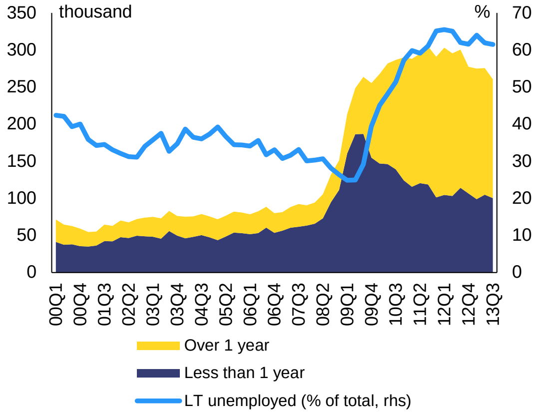
The boom-bust cycle has affected distinct segments of the labour force very differently. The nature of the cycle and the structure of Ireland's economy, including the prominence of the FDI sector (see section 3.4), mean that certain classes of workers, in particular those with low or intermediate skills, have been affected significantly more than others. A number of salient developments in the labour markets over the past

([41]) This loss is equivalent to about 10% of total peak-time employment.

few years need to be highlighted as they affect the policy responses necessary to address the imbalances and the sharp rise in unemployment.

Unemployment has become largely of a long-term nature and severely affects the youth. As the crisis unfolded and became protracted, unemployment has taken an increasingly long-term nature. By Q3 2013, just over 60% of the unemployed had been without a job for over a year, and 45% had been separated from employment for more than 2 years. Such a high level reflects the specificity of many construction sector skills and their difficulty to transfer to other types of employment. It also compares poorly with the EU average, in contrast to Ireland's position prior to the crisis, when long-term unemployment had come down to around 25% and well below the EU average. In addition, the high prevalence of long-term and very long-term unemployment generates high risks of losses of tangible and intangible skills for the workers affected and a genuine danger of hysteresis. The crisis has taken a particular toll on the youth at all skills levels, who have faced difficulties in integrating the job market in recent years. The unemployment rate among the 15-24 years old peaked above 30% in late 2012 and early 2013.

Graph 3.50: **LT unemployment rises in parallel with the increase in unemployment rate**



Source: Eurostat

The prevalence of low work intensity is a serious concern. Ireland's share of households with low work intensity is exceptionally high at 24.1% in 2011, compared with an EU average of 10.3%. The prevalence of low work intensity has also risen in recent years with the general increase in unemployment and its long-term nature. This point to the concentration of joblessness at household level and raises specific social and policy concerns.

Unemployment and inactivity traps have emerged. Unemployment benefits are paid under a dual system of jobseeker's benefit (JB) and jobseeker's allowance (JA). JB is not means-tested and is provided to eligible jobseekers for a period of up to 9 months. ([42]) Although the payment is graduated according to previous earnings, it is capped at a maximum weekly rate of EUR 188 ([43]), which effectively applies to most claimants. If not or no longer eligible to JB, jobseekers are eligible to JA. JA is paid at the same weekly rate of EUR 188 for people above 26 years of age and without dependents. It is means tested but not time-bound. In addition, jobseekers may be eligible for additional benefits, most importantly the rent supplement (housing support) and the medical care (free medical care and prescriptions).

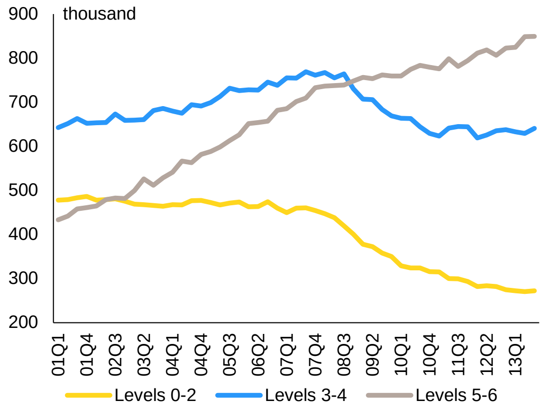
Replacement rates are comparatively high for certain classes of unemployed. The flat structure of unemployment benefits under the JB and JA system, the unlimited duration of JA and the availability of supplementary payments have several implications: (1) replacement rates are relatively low in the initial phase of unemployment in comparison with EU or OECD countries, particularly for average and above average income earners; (2) replacement rates are relatively high for the long-term unemployed, particularly for below average income earners, which is likely the case for the majority of the long-term unemployed; and (3) additional benefits, in particular the rent supplement and the medical card, further increase the replacement rates for certain segments of the population. ([44])

Skills mismatches have emerged with the rebalancing of the economy. As indicated in section 3.3, Ireland's economy has gone through a major rebalancing process over the past few years,

([42]) Eligibility conditions include prior contributions to pay related social insurance (PRSI) for a determined number of weeks, in addition to being available for and genuinely seeking work.
([43]) Excluding additional payments that might be claimed for dependents.
([44]) Standardised data on replacement rates are compiled by the OECD Directorate for Employment, Labour and Social Affairs.

part of which has been of a "destructive nature" with the collapse of the construction sector and the sharp fall in domestic demand. The reallocation of resources towards the tradable sector has also had consequences for the structure of the demand for labour.

Graph 3.51: **Employment at low skills levels has declined markedly**

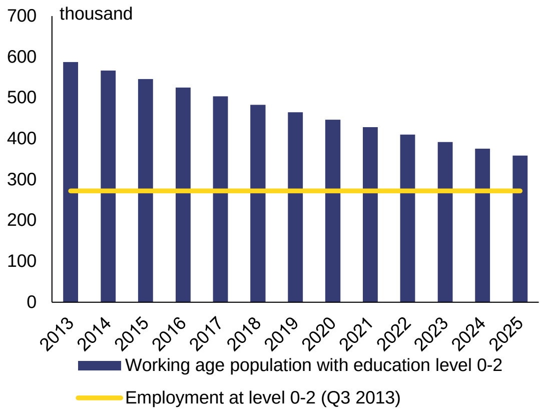


Source: Eurostat

A number of factors drive skills imbalances. First and foremost, the transformation of the Irish economy provides increasingly less room for low-skilled workers. Second, while Ireland has the highest tertiary education attainment rate in the EU, there remains a large number of workers with education level 0-2. ([45]) Aging will not naturally address the labour supply and demand mismatch at this level of skill. In addition, Ireland's system of further education provides insufficient room for valuable re-skilling and up-skilling opportunities.

([45]) The United Nations Educational, Scientific and Cultural Organisation (UNESCO) developed the International Standard Classification of Education (ISCED) for cross-country comparison purposes. Levels 0-2 correspond to education up to lower secondary level. Levels 3-4 correspond to education up to post-secondary non-tertiary level. Levels 5-6 correspond to first and second stage tertiary education.

Graph 3.52: **Current and prospective active age population with low skills level far exceeds current labour demand**

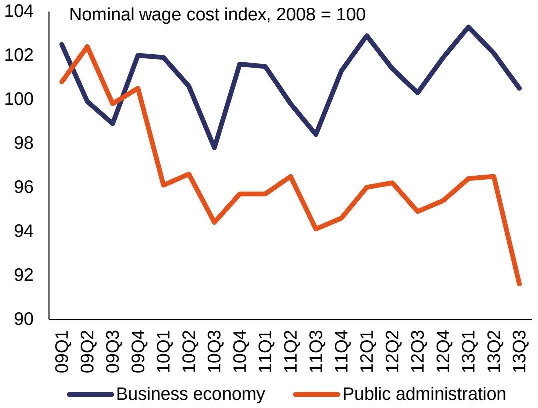


Source: Eurostat

The imbalances that have led to the high level of unemployment have been partly reduced or are being addressed, but challenges remain. Wage developments have been subdued in the past few years and have cut real labour costs. The high level of unemployment placed a cap on nominal wages since the onset of the crisis and put an end to the long rising trend in nominal wage costs. Despite the relatively high level of labour market flexibility, however, nominal wages in the private sector have proved sticky as elsewhere. In contrast, public service wages were cut on several occasions, which has reduced the positive wage differential between the public and private sector ([46]).

([46]) A number of studies, including by the Central Statistics Office (CSO) and the ECB point to a positive wage gap in favour of the public service, after controlling of variables like education, experience, age, gender or size of the employer. The gap is most significant for the lower part of the income distribution and falls for higher income earners to the point of becoming negative for top percentiles. The gap has been reduced with the pay cuts of 2009-2010, and will be further reduced for high-income earners as a result of the Haddington Road agreement.

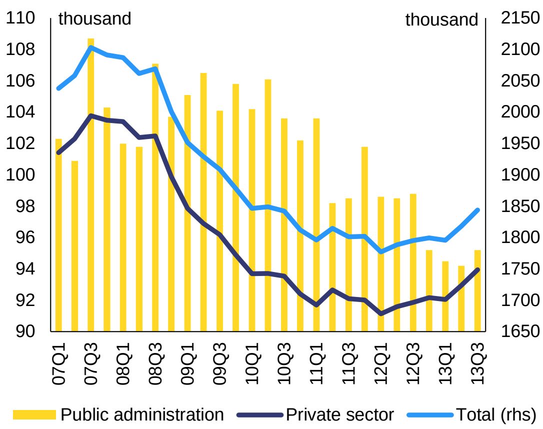
Graph 3.53: **Nominal wages have been stagnant in the private sector and fell in the public sector**



Source: Eurostat

New vacancies are being filled rapidly and private employment is rising. Recent labour market developments (see section 2) are indicative that frictions on the labour markets are relatively limited at this stage: the increase in labour demand is translating in rising employment as vacancies are being filled rapidly. This is also indicative that structural unemployment may not have risen as much as a result of the crisis, as may have been estimated at first and under standard econometric techniques.

Graph 3.54: **Private sector employment recovers**

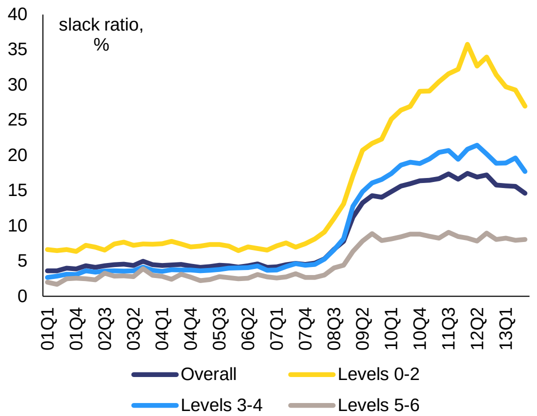


Source: Eurostat

Slack in the labour force is high overall, but relatively thin for certain categories of skills. Total labour supply remains significantly larger than demand at this stage, but the degree of slack differs widely across skills levels. While the slack ratio ([47]) is at around 30% for education levels 0-2, it at about 20% for education levels 3-4 and down to 8% for education levels 5-6. Although the latter is significantly higher than in the pre-crisis levels when it hovered around 2%, it is indicative that relatively little excess capacity exists in the high-skill segment of the labour market and that pressures and skills shortages could materialise relatively rapidly if the recovery on the labour market is sustained.

The post-crisis level of structural unemployment remains uncertain. The relatively low slack ratio at education level 5-6 also highlights the potential risk that Ireland may soon confront if past trends in employment growth (i.e. a continued increase in employment at the high-end of the skills spectrum) continue: that vacancies may increase further without a corresponding rise in employment and that the unemployment rate may be stuck at a structurally high level. Ireland's ability to generate job creation at the intermediate skill level and its capacity to offer re-skilling and up-skilling opportunities to its (long-term) unemployed population will be critical in this regard.

Graph 3.55: **There is relatively little labour market slack at high levels of education**



Source: Eurostat

([47]) The slack ratio is measured as the number of jobseekers (active population minus employed population) divided by the number of employed people at a given level of skills.

4. POLICY CHALLENGES

Significant imbalances started to unwind in 2007 triggering a major adjustment and rebalancing process. A property market and credit boom in the run up to 2007 was accompanied by a loss of competitiveness and widening current account deficits. Property-related lending led to rising levels of private sector indebtedness, while weak financial regulations further undermined the balance sheet of banks. The bursting of the bubble and economic downturn eventually led to the government's intervention in the banks and a transfer of liabilities from banks to the government. Government borrowing undertaken to rescue banks and under the EU/IMF-supported programme led to a rise in external liabilities reflected in the highly negative NIIP.

Completing the path of macroeconomic adjustment towards balanced and sustainable growth can only be achieved with further policy efforts. The economy has undergone a significant amount of adjustment since 2009. The current account has swung into surplus, private sector debt started to decline, the fiscal position has improved, labour costs and unemployment have declined, and financial sector repair is on-going. Nonetheless, macroeconomic imbalances still exist giving rise to important policy challenges.

Lowering government debt through fiscal consolidation

Government debt reduction is critical to reducing vulnerabilities and restoring the long term sustainability of public finances. The current deficit levels are clearly unsustainable, which makes strict adherence to the adjustment path laid out in the Council recommendation under the EDP all the more essential. Beyond the correction of the excessive deficit, it will also be important that the conditions of the preventive arm of the SGP are met so as to attain a balanced fiscal position as soon as possible. Strengthening multi-year budgeting rules would also ensure that discretionary changes to the government expenditure ceiling are limited to well-defined and a restricted number of conditions. Certain aspects of fiscal data reporting and analysis could also be improved. The expected recovery of economic growth will help the fiscal adjustment over the medium-term but additional efforts could be required if growth surprises on the downside. In this regard, privatisation revenues are an opportunity to reduce public debt. Careful monitoring and management of contingent liabilities is also essential in order to not derail future debt reduction.

Reducing financial sector vulnerabilities

Financial sector repair is critical to revive lending and improve the soundness of banks. Non-performing loans remain high and maintaining or raising mortgage and SME arrears restructuring targets is crucial to improve bank profitability. Developing a strategy to restructure commercial real estate arrears would also help greatly. Further developing schemes to ease SME access to finance is important as credit conditions for domestic SMEs remain tight and as this would support growth. Market-based options to reduce the profitability drag to banks from tracker mortgages could also be explored further. It is also important to have the recently enacted central credit register operational as soon as possible as this would improve banks' risk management. Proactive and careful implementation of new financial legislation, especially related to the new personal insolvency regime and facilitating banks' access to collateral, is critical. Safeguarding the capital position of banks would also help them confront challenges linked to the EU-wide stress tests in 2014.

Easing private and household debt

Financial policies that lower private domestic debt, particularly household debt, are important for supporting future growth. In the near term, ongoing household deleveraging is likely to continue weighing on growth, though less so than in the past. In the medium term, the reduction of financial uncertainty for individuals and banks through NPL resolution can have significant confidence effects. Financial sector policies that encourage mortgage debt restructuring will aid the reduction of household debt as banks propose sustainable arrears resolution through partial debt relief offers to distressed mortgage holders. This will also lessen the impact debt deleveraging has on private consumption. Careful monitoring of other regulatory measures that aid resolving distressed mortgages is particularly relevant, particularly as concerns recent changes to personal insolvency and bankruptcy reforms and to the repossession regime and consumer protection. Effective implementation of these changes would enhance debt resolution. In addition, labour policies aimed at reducing unemployment will boost disposable income and aid household debt reduction. Other financial policies that encourage the restructuring of SME and commercial debt would also help the reduction of private debt.

Cutting long-term unemployment through more reforms

Continued labour market reforms will facilitate further rebalancing and declines in the unemployment rate. Employment gains will also continue to support household deleveraging. Labour market activation policies could be strengthened, especially in the government delivery of support services to the long-term unemployed and identifying job opportunities. Further education and training (FET) reforms are important to reduce skills mismatches, especially increasing the relevance of FET programmes for jobseekers and employers and improving the assessment of skill needs. It would also be critical to ensure that the new institutional setup for FET works smoothly, especially with the allocation of funds to the new education and training boards (ETBs) which would entail an improved monitoring system to better measure outcomes and channel funds where best results are achieved. Policies aimed at maintaining recent wage moderation and at avoiding inactivity traps are also important to maintain employment gains.

Consolidating the reduction of external imbalances

Fiscal, labour and financing reforms will protect external competitiveness. Government debt reduction would address concerns over the large negative NIIP as public external debt is reduced. Policies incentivising resource reallocation into the tradable sectors could be further explored, particularly for domestic firms as few are export-orientated. Measures which assist the development of SMEs, alongside international investment into the economy, would be in the best interests of Ireland's long-term economic growth. In this regard, on-going initiatives boosting access to finance for SMEs are important to expand and make more effective. Government policies that ensure continued wage moderation and the reskilling of the labour force are also key as they would lock in recent productivity increases and labour cost reductions.

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