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EUROPEAN  
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**COMMISSION STAFF WORKING DOCUMENT**

**Economic Adjustment Programme for Ireland**

**Winter 2012 Review**

*Accompanying the document*

**Proposal for a**

**COUNCIL IMPLEMENTING DECISION**

**amending Implementing Decision 2011/77/EU on granting Union financial assistance to  
Ireland**

{COM(2012) 792 final}

European Commission

Directorate-General for Economic and Financial Affairs

# **Economic Adjustment Programme for Ireland**

## **Winter 2012 Review**

## ACKNOWLEDGEMENTS

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

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## Executive summary

*A joint EC-ECB-IMF mission visited Dublin during 16-25 October to conduct the 8<sup>th</sup> review of the EU/IMF financial assistance programme for Ireland. The mission updated the programme macroeconomic framework by revising down somewhat the forecast for real GDP growth in 2013, mostly as a reflection of the lower pace of economic activity now envisaged for Ireland's key trading partners and somewhat weaker domestic demand. Forecasts for key aggregates in nominal terms for 2013 have been kept broadly unchanged, however, reflecting higher-than-expected inflation. Unemployment is envisaged to remain broadly stable at around 14.8% in 2013, but is increasingly long-term in nature—a key policy concern.*

*Programme implementation remains strong overall:*

- As regards fiscal consolidation, central government cash figures through September 2012 were better than profiled, mostly on account of over-performance in tax revenue and lower-than-profiled capital spending, but the social welfare and health budget lines recorded overruns. Despite weakening in tax revenue in the fourth quarter, the 8.6% of GDP deficit ceiling is within reach. Two pieces of legislation advancing the reform of the structural fiscal framework (one formalizing the fiscal council and enabling ratification of the fiscal compact and the other giving a legal basis to medium-term expenditure ceilings introduced last year on an administrative basis) were also published.*
- As regards banking supervision and financial sector reform, several pieces of legislation were introduced to the Dail by end-September as required. While their content was broadly in line with programme understanding, Commission services found that the unduly high EUR 3 million cap on eligible secured debt raises implementation risks for the new personal insolvency regime. Separately, the credit institutions resolution fund levy, which in some key respects (notably, the basis of the levy and the target size of the resolution fund) is not in line with the European Commission proposal for the EU directive establishing a framework for the recovery and resolution of credit institutions and investment firms will have to be reviewed when the EU legislation is published. An advisory service for distressed mortgage borrowers was also introduced. Banks continue to make progress towards their deleveraging targets and to advance operational restructurings, but concerns remain on the prospects for their profitability in the medium term and the scarcity of new lending to underpin economic activity.*
- Progress continued on: (i) reforming labour market activation policies, though the pace should be accelerated and their coverage extended to reach a greater share of long-term unemployed; (ii) putting water service provision on a sound footing, though implementation risks are important as meter installation has yet to start and the authorities are concerned that there might be resistance to introduce charges ahead of a full roll-out of meters; (iii) preparing select state assets for eventual disposal; and (iv) reforming the sectoral wage setting mechanisms (legislation for which has been passed).*

*Policy discussions were, as usual, frank and constructive and underscored that key risks and challenges remain:*

- Authorities reiterated their commitment to observe the agreed fiscal consolidation path. In particular, they have committed to deal in a durable way with the spending pressures experienced in the health sector (estimated to have caused the health budget baseline to increase by EUR 700 million). The mission stressed the need to*

*ensure that measures are durable and growth-friendly and that they minimise the burden of adjustment on the most vulnerable. The estimated 2012 outturn weakened somewhat as from October 2012 with higher expenditure overruns and somewhat lower-than-previously-expected tax revenue projections. Against this backdrop, the 2013 budget targets the agreed deficit ceiling of 7.5% of GDP in 2013 by introducing revenue and expenditure measures in the order of EUR 1.4 and 1.9 billion respectively, as well as increasing dividends from state-owned companies. The deficit target for 2013 is predicated upon a macro scenario that is slightly more optimistic than the one contemplated by the Troika. Revenue measures include the introduction of a value-based property tax, a broadening of the labour tax base, as well as increases in motor tax and excises. Expenditure savings are expected to be achieved by reducing child benefit rates, further reducing the number of public service employees, increasing student contributions and through other saving measures. The authorities also confirmed their commitment to reduce the deficit to 5.1% of GDP in 2014 and 2.9% in 2015, in line with the programme.*

- In the financial sector, key challenges include how to address the banks' growing arrears backlog and ensure that they can resume playing an active role in support of the recovery. While the pace of mortgage arrears' formation has decelerated in recent months, progress in dealing with long-term non-performing loans has been slow and needs to be accelerated under active supervision by the authorities. Failure to decisively act on the mortgage arrears would pose increased risks to banks' future capital positions. The mission also emphasised that, for the reformed personal insolvency regime and the mortgage arrears strategy to be effective, it is essential to remove the identified impediments to repossession of collateral as a last resort to dealing with unsustainable debts, while recognising that it is desirable to keep families in their homes wherever possible. There was broad agreement that bank profitability should be enhanced with continued progress on operational restructuring and a concerted exit from expensive liability guarantees amid growing market confidence in Irish banks. Another key policy priority is to ensure that potential obstacles to credit extension for SMEs are identified and addressed, given the importance of this sector for future job creation.*
- The increasingly long-term nature of unemployment is a particular source of concern. While there is scope to speed up the pace and expand the coverage of active labour market policies, the bursting of the real estate bubble has generated a structural shift in the labour market and rising skills mismatches. Averting a "lost generation" will require a convergence of efforts to improve the functioning of the labour market, re-skill the long-term unemployed, foster job creation, and ensure that an adequate incentive structure is in place to optimally benefit when economic recovery gathers pace.*
- As far as the sovereign funding outlook is concerned, in the course of 2013 the authorities intend to maintain a comfortable cash position covering broadly 12 months of future financing needs in preparation for the exit from the programme.*

#### **Disbursement**

*Successful completion of this review would trigger the release of EUR 0.8 billion from the EFSM/EFSSF, EUR 0.9 billion from the IMF, and EUR 0.5 billion from the UK under its bilateral loan.*



## 1. Introduction

This report covers recent macroeconomic and financial developments, programme implementation, and the main challenges ahead, as assessed by the joint EC/ECB/IMF staff mission to Dublin on 16-25 October 2012 in the context of the eighth review of the economic adjustment programme, as well as the associated policy discussions with the Irish authorities.<sup>1</sup>

Successful completion of this review would trigger the release of EUR 0.8 billion from the EFSM/EFSF, EUR 0.9 billion from the IMF, and EUR 0.5 billion from the UK under its bilateral loan. This would bring disbursements to EUR 56.6 billion, representing 84% of the total international assistance of EUR 67.5 billion under the programme.

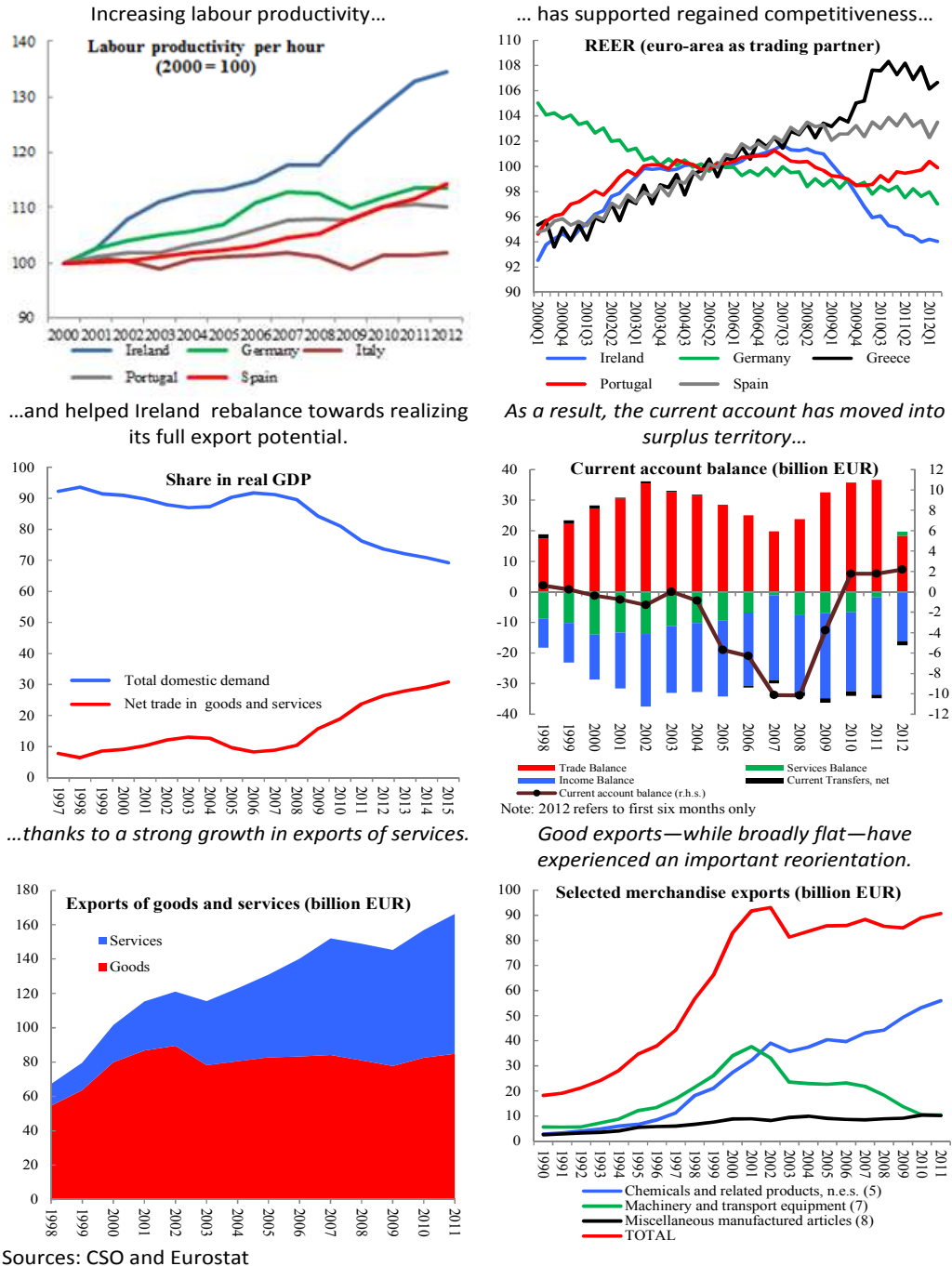
## 2. Macro-fiscal and financial developments

**Macroeconomic developments in the second quarter of 2012 were broadly in line with programme projections.** There was essentially no quarter-on-quarter (q-o-q) growth in real GDP in the three months to June in seasonally adjusted (sa) terms. Domestic demand continued to be weak, with declines both on q-o-q (sa) and annual terms in all of its components, and especially the volatile investment category. The 0.4% (q-o-q, sa) decline in private consumption represented a notable slowdown in the pace of contraction, in line with high-frequency indicators such as retail sales, which were essentially flat. Exports fell in quarterly terms, as goods exports were hit by weakening demand from trading partners as well as possible first signs of the recent strong growth of chemical exports reversing (the so-called "patent expiration cliff", Figure 1). The year-on-year (y-o-y) increase in export growth of 2.1% continued to be robust, especially in the services category, supported by some regaining of the competitiveness lost in the pre-crisis boom (Figure 1). Together with relatively weak imports, this led the balance of payments to record a surplus of about 8% of GDP, suggesting that Ireland is well on its way to a third year of surplus in the external accounts. The strong q-o-q increase of GNP (+4.3% , sa) was a welcome development, but mainly reflects factor inflows from Irish multinationals unrelated to the performance of the Irish economy. The net international investment position improved marginally, a reminder that the unwinding of external imbalances incurred prior to the crisis takes time. Competitiveness indicators continued to improve steadily, although not at the pace observed in the immediate wake of the crisis.

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<sup>1</sup> This report reflects information available as of 13 December 2012.

**Figure 1: Productivity, competitiveness, and rebalancing**



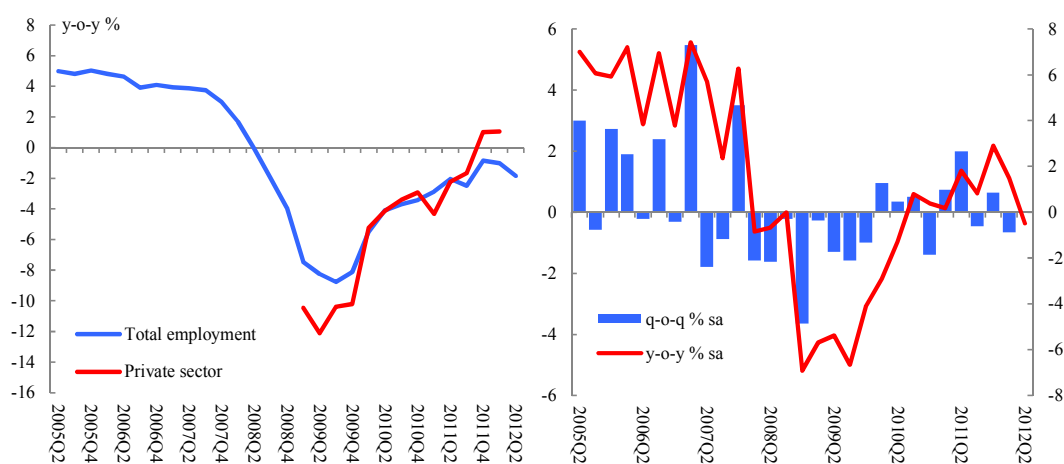
**More recent high-frequency indicators have been somewhat mixed.** The manufacturing and services PMI grew strongly in November and are at historically high levels, although the rates of increase slowed in manufacturing output and new orders. On the other hand, industrial production fell by almost 18% in annual terms in October after an unexpectedly large fall in September on an annual and monthly basis led by developments in the pharma-chemical sector. Early indicators of domestic demand showed a more coherent picture, with the services index expanding at an accelerating pace in annual terms in November. Although residential property prices are still down compared to last year's levels (by 8% on an annual basis as of October) there are

emerging signs of stabilization, especially in urban areas, with a slowing pace of annual decline and some increase in rents.

**Inflation has been moderating in recent months.** With relatively strong price pressures from energy and services (especially insurance) earlier in the year and temporary VAT effects moderating, HICP inflation fell in October, bringing the annual average rate in January-October 2012 to 2.0%.

**Despite a slight further deterioration of labour market conditions in the third quarter, the situation appears to have broadly stabilised.** Employment fell by 0.3% on a quarterly basis (sa) in Q3, following similar declines in the first two quarters (Figure 2). The y-o-y rate of decline in employment decreased from 1.3% in Q2 to 0.2% in Q3. Declines in Q3 originated mainly from the public service, where the head count fell by 4.1% in annual terms on the back of retirements triggered by expiring favourable treatment of pensions and lay-offs of temporary Census workers.<sup>2</sup> Private sector employment appears to be stabilising with marginal declines in the last two quarters. Due to migration-driven decreases in the labour force, the unemployment rate was virtually unchanged at 14.8% (sa) for the third consecutive quarter in Q3 although the number of unemployed individuals fell for the first time since early 2005.

**Figure 2: Growth in employment and real GDP**



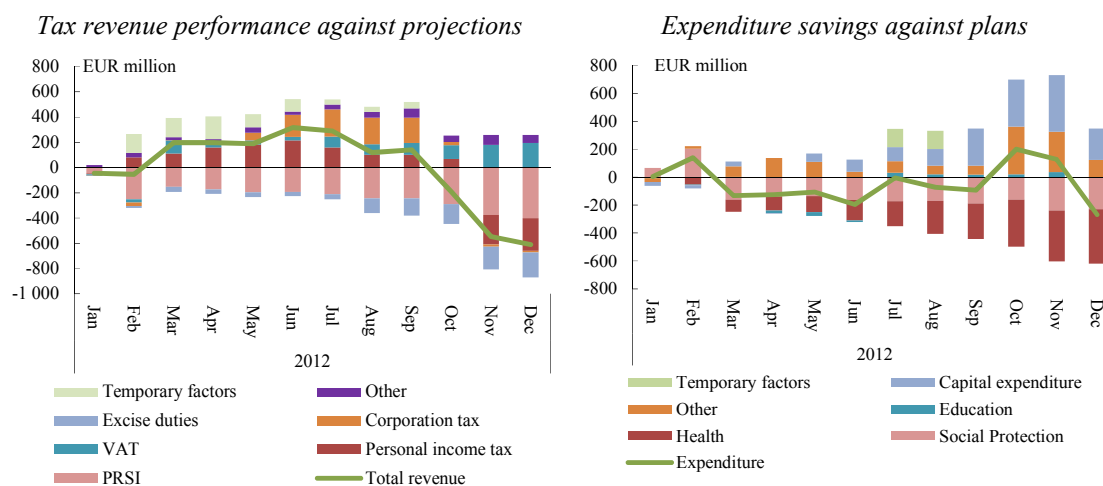
Source: CSO

**Fiscal performance weakened in the second half of 2012.** Tax revenue was better than expected in the first half of the year but underperformed later in the year and is estimated to be 0.4% of GDP below the 2012 budget plans (Figure 3). This shortfall is partly offset by higher-than-budgeted revenue from the sale of mobile telephony licences (0.2% of GDP). Spending pressures in social and health services continued into the second half of the year, on account of higher-than-budgeted unemployment numbers and continued slippages/delays in the implementation of planned health measures (these account for a large part of the health overruns—see Section 5 below and Table A1). The overruns in health and social protection (0.4% of GDP) are expected to be partly offset by capital

<sup>2</sup> The window for favorable treatment, which allowed for pension entitlements to be calculated based on a pre pay-reduction basis, expired in February. Retirements have nevertheless continued in the following quarters.

expenditure savings (0.1% of GDP) and lower-than-planned spending by other departments (0.1% of GDP). While cash interest expenditure is expected to be lower than planned, an increase in negative interest cash-accrual adjustment implies a lower net effect on the general government balance (0.3% of GDP). Table A2 compares the expected 2012 fiscal outturn with the budget plans. The 2012 fiscal deficit outturn is estimated at 8.2% of GDP, compared to the target of 8.1% of GDP on a like-for-like basis<sup>3</sup>.

**Figure 3: Fiscal performance in 2012**



Source: 2013 Budget, Department of Finance and Commission service estimates

Notes: Figures are consistent with the monthly projections published in May 2012 with corresponding adjustments for the previous months. Tax and expenditure items are adjusted for timing-related temporary factors, which in particular improved corporation tax outturn against profile in February-June and net health expenditure in July-August. Expenditure includes departments' own receipts (appropriations-in-aid), except for PRSI revenue, which is presented among tax revenue. Capital expenditure is showed separately from current departmental expenditure.

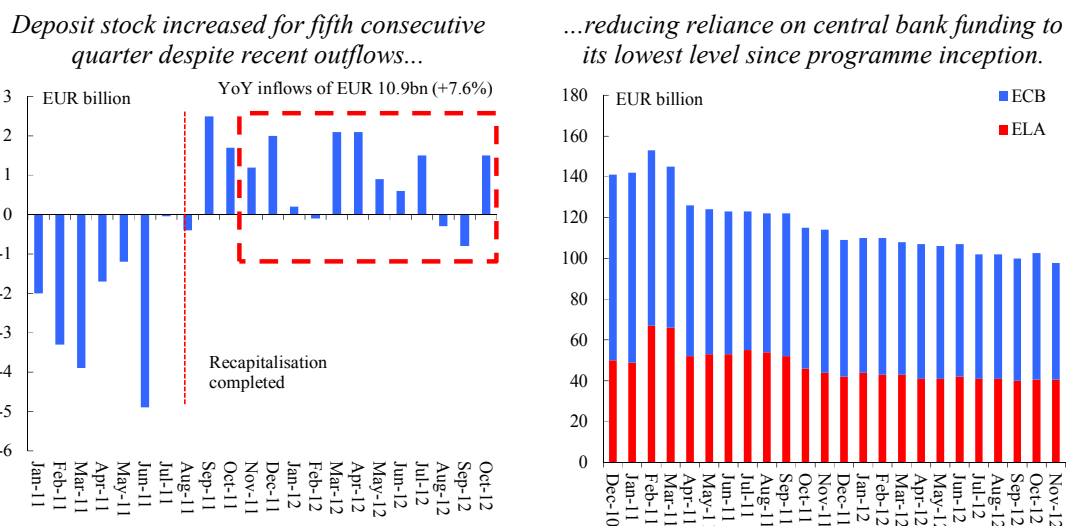
**Banks continue to deleverage their balance sheets.** BOI has already met its 3-year non-core asset disposal target and AIB achieved 83% of its original 3-year deleveraging target by end-October, (both banks have done so in line with PLAR-assumed discounts). PTSB's progress to date has been limited, with EUR 3.8 billion of net customer loan balance reduction and no material asset disposals completed by end-September. Following agreement with programme partners, in September the CBI informed the bank that it would await the outcome of ongoing discussions on its revised restructuring plan before it considers PTSB's future deleveraging requirements. As of end-September, total net loan balances at the covered banks<sup>4</sup> have decreased by almost EUR 50 billion from end-December 2010 (of which EUR 13.8 billion year to date), representing over 70% of the

<sup>3</sup> The budget for 2012 announced in December 2011 targeted a deficit of 8.6% of GDP. The April 2012 stability programme updated the deficit target to 8.3% of GDP, including developments since the budget. An upward revision of nominal GDP since the stability programme further reduced the deficit target to 8.1% of GDP.

<sup>4</sup> Banks covered by the 2011 PCAR/PLAR exercise, i.e. BOI, AIB/EBS, and PTSB.

original 3-year programme deleveraging target.<sup>5</sup> An additional EUR 13.1 billion of deleveraging has been completed by IBRC over the same period. A further EUR 2 billion of asset disposals have been sale-agreed as of mid-November, and are expected to settle by year-end.

**Figure 4: PCAR banks' funding developments**



Source: Department of Finance  
 Note: Figures are consolidated and include deposit inflows/outflows for foreign subsidiaries of PCAR banks.

Source: Central Bank of Ireland, Department of Finance  
 Notes: Data covers BOI, AIB/EBS, PTSB and IBRC; ELA is proxied by the CBI's "other assets" series through March 2012 and by "other claims on euro area credit institutions" thereafter; November data is through 7 November only.

**These deleveraging efforts, continued deposit inflows and recent market issuance have contributed to a gradual decline in covered banks' reliance on central bank funding.** Despite recent outflows (EUR 1.1 billion in August-September) their combined deposit stock was about EUR 11 billion higher in October than a year earlier, having recorded net inflows of EUR 14.7 billion since the third quarter of 2011. As a result, loan-to-deposit ratios at the pillar banks have steadily declined, with AIB's falling below 120% by end-October and BOI's below 130% in November. Reliance on central bank funding has reduced correspondingly, and was more than EUR 55 billion (36%) lower in early November relative to the February-2011 peak (Figure 4). In addition, in mid-November BOI issued a EUR 1 billion unguaranteed covered bond,<sup>6</sup> collateralised by Irish residential mortgage loans, the first such issuance since before the launch of the programme, followed by a similar issuance of EUR 500 million by AIB later in the month. The relatively competitive pricing (Figure 5) and strong (largely foreign) investor demand are important signs of improved market funding prospects for Irish banks.

<sup>5</sup> The original programme deleveraging target required a EUR 70.2 billion net loan balance reduction across the covered banks by end-2013, reflecting non-core asset disposals, amortisation and FX/other adjustments. The programme deleveraging monitoring framework was since modified (see Commission Services [report](#) on the 7th programme review (e.g., page 25).

<sup>6</sup> This is not reflected in the above figure for the reduction in the banks' reliance on central bank funding.

## Figure 5: Unguaranteed covered bonds issued by select European banks, 2012

*Pricing on Irish banks' recent covered bond issues compare favourably with European peers'*

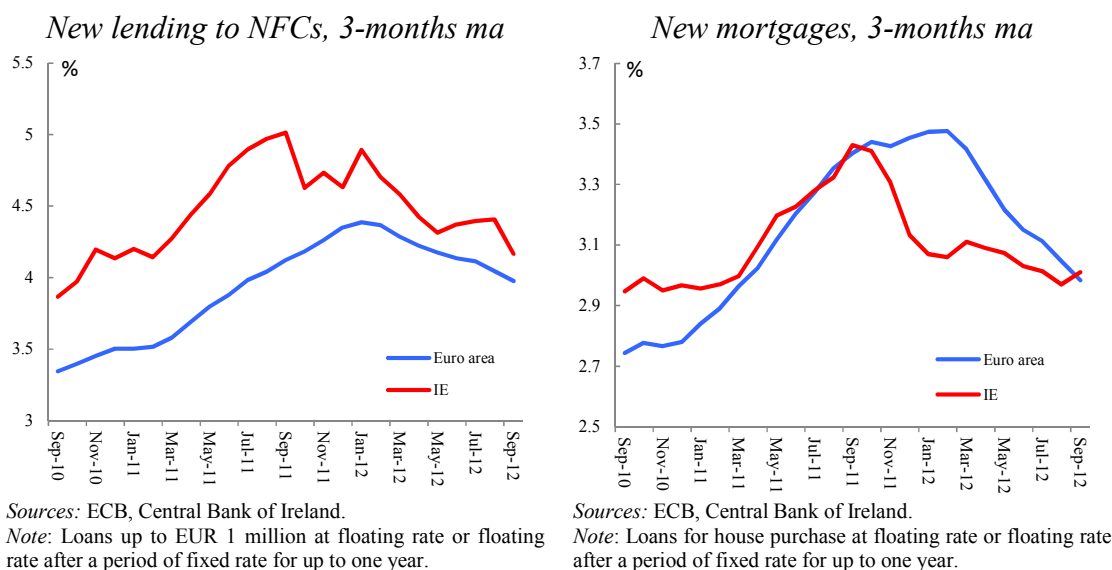
Issue Date	Borrower	Moody's/S&P/Fitch	Country	Issue Size (€ bn)	Coupon (%)	Maturity	Spread
1-Feb-12	Santander	Aaa	Spain	2.00	3.250	17-Feb-15	210
6-Feb-12	Banco Sabadell	Aaa	Spain	1.20	3.625	16-Feb-15	250
7-Feb-12	Banesto	Aaa	Spain	0.50	3.750	17-Jun-16	235
8-Feb-12	Caixabank	Aaa/AAA	Spain	1.00	4.000	16-Feb-17	248
22-Feb-12	Bankia	A2/AA	Spain	0.50	4.000	28-Feb-14	290
24-Feb-12	Cajamar	AA-	Spain	0.50	5.000	28-Feb-16	390
12-Mar-12	Bankinter SA	Aa2	Spain	1.00	4.125	22-Mar-17	268
21-Mar-12	Banco Popular	Aa2	Spain	0.60	4.125	30-Mar-17	255
18-Apr-12	Unicredit	Aaa	Italy	0.50	2.625	25-Apr-19	88
14-Aug-12	Unicredit	A2/AA+/A	Italy	0.75	4.000	31-Jan-18	290
3-Sep-12	Unicredit	Aa1/AAA	Italy	0.50	1.875	12-Sep-22	22
10-Sep-12	Banesto	A3	Spain	0.50	4.750	24-Jan-17	395
11-Sep-12	Banco Sabadell	A3	Spain	0.50	4.250	19-Sep-14	375
17-Oct-12	Unicredit	A2/AA+/A	Italy	0.25	4.000	31-Jan-18	190
18-Oct-12	Bank	A3/A	Spain	0.50	3.875	30-Oct-15	335
<b>13-Nov-12</b>	<b>Bank of Ireland</b>	<b>Baa3</b>	<b>Ireland</b>	<b>1.00</b>	<b>3.125</b>	<b>20-Nov-15</b>	<b>270</b>
22-Nov-12	Intesa Sanpaolo	A2	Italy	1.25	3.625	5-Dec-22	200
26-Nov-12	BBVA	A3	Spain	2.00	3.500	5-Dec-17	260
<b>28-Nov-12</b>	<b>Allied Irish Bank</b>	<b>Baa3/A/A</b>	<b>Ireland</b>	<b>0.50</b>	<b>3.125</b>	<b>4-Dec-15</b>	<b>270</b>
30-Nov-12	La Caixa	Aaa/AAA	Spain	0.20	5.000	22-Feb-16	450

Source: Bloomberg, Bond Radar

Note: Spread and ratings indicated as at times of issue; all unguaranteed covered bonds issued by banks from vulnerable or programme countries through 5 December 2012 included.

**Monetary conditions have broadly continued to ease.** Interest rates on new loans to non-financial corporations (NFCs) have been on a declining path for the past 12 months, reflecting reductions in Euribor, as have interest rates on new mortgages. They remain volatile, however, and banks increased their variable rates by 21 bps on average in September to improve their net interest margins (Figure 6). Rates on consumer credit not related to house purchase have also been on a steady downward trend since the beginning of the year, with floating and up to one-year fixed rates lower by almost 80 basis points since January.

**Figure 6: Evolution of key lending rates**

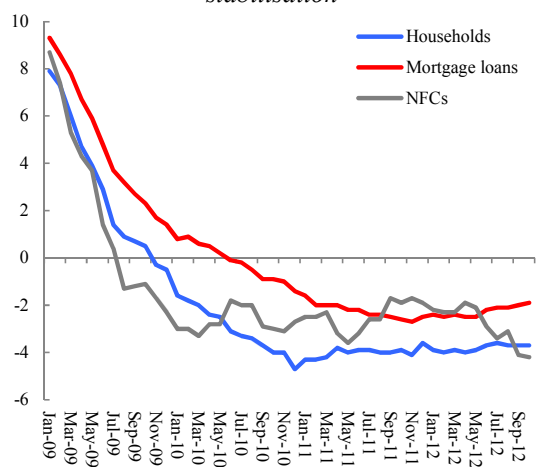


**Yet the flow of credit to the economy remains weak.** Net lending to households has continued to contract, though the flow of loans for house purchase in the third quarter of 2012—EUR 0.7 billion of new mortgages issued (drawn down)—was the largest since Q4 2010 and almost 27% more than in Q2 2012. Over 90% of these loans went to the first-time buyer and mover-purchaser segments (Figure 7). This is consistent with emerging signs of stabilisation in domestic residential property prices, although many transactions continue to be carried out in cash.<sup>7</sup> Net lending to NFCs also continues to decline, though this partially reflects lower demand for investment spending, the gradual shift to shorter-term facilities such as overdrafts (which continue to increase, albeit at a slower pace), and the sector's high leverage, including as a result of legacy real estate exposures. Credit to indigenous SMEs (excluding property and financial intermediation) is still contracting, though the annual rate of decline fell to 4.9% by end-September from 8.9% a year earlier. Profitability challenges and the still-sizeable funding gap might hinder banks' capacity to extend new lending, which could represent a downside risk for the recovery. Other constraints include the difficulty of disentangling viable SME activities from their legacy debts and the need for banks to enhance their capacity to assess SMEs' creditworthiness based on their cash flow rather than—as was often the case during the boom years—on their property collateral (see Section 6). Foreign-owned Irish-resident banks are also contracting their exposure to domestic agents.

<sup>7</sup> Based on the recently-launched residential property register data base, in the first three quarters of 2012 approximately 45% of transactions have been carried out in cash.

**Figure 7: Bank loan developments**

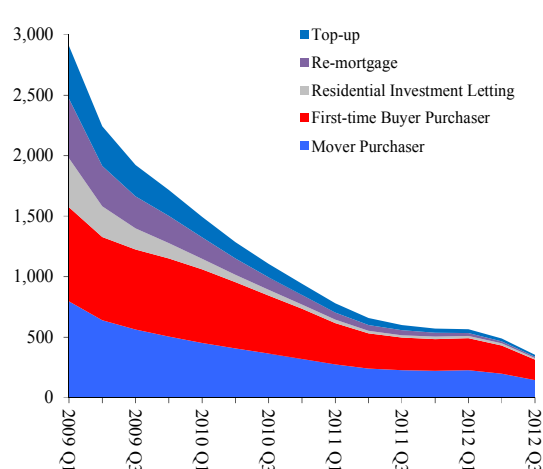
*Lending to households and NFCs continues to contract, though mortgage credit showing signs of stabilisation*



Source: Central Bank of Ireland

Notes: (i) Lending to NFCs includes SMEs which account for about 60%; (ii) lending to households includes mortgage, consumer and other loans

*First-time-buyers and mover-purchasers account for the largest share of new mortgage lending*



Source: Irish Banking Federation

Note: Figures relate to all new lending (flows) secured by residential property extended by IBF's members (95% of total market)

**Despite recent signs of stabilisation, the increasingly long-term nature of mortgage arrears is a persistent source of concern.** While arrears balances on owner-occupier mortgage accounts less than 90 days past due (dpd) contracted over the two quarters to end June 2012 (by 5.6% and 1.9% QoQ respectively), an increase was recorded in Q3 which however was reportedly due to a technical timing issue.<sup>8</sup> Excluding the impact of this, a decline of [1.3%] in arrears balances of less than 90 dpd is estimated for the quarter. The deceleration in the pace of formation of new arrears reflects a stabilisation in the macroeconomic environment and some initial effectiveness in covered banks' strengthened efforts to tackle arrears early on. However, arrears balances on accounts more than 180 dpd continue to increase reaching over 14% of the total stock of owner occupier and investment property mortgages at end September. This highlights the urgent need for banks to implement advanced loan modification options to their long-dated arrears' stock in earnest. Curing late arrears is of paramount importance for restoring profitability and minimising potential further loan losses.

**Taking advantage of improved sentiment towards Irish bonds, the authorities have added to their cash buffers.** Yields on Irish government bonds have declined steadily in recent months and markedly since the supportive statements from euro area leaders in June and July (the yield on the 2020 bond fell from 6.2% in July to 4.5% in December). While the ratings by the major credit rating agencies have remained unchanged since the downgrades at the beginning of last year, one rating agency upgraded Ireland's outlook to stable from negative in mid-November (Figure 8). After the summer issuances of short-term T-bills and long-term bonds, Ireland made two T-bill issuances in October and November, with further reductions in the yields (0.55% in November, down from 0.7% in

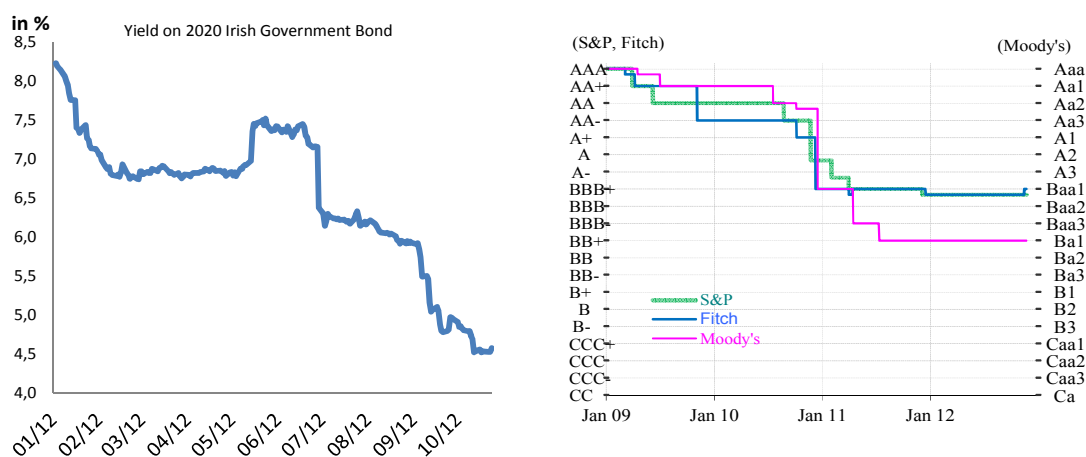
<sup>8</sup> See [Information release](#) of the Central Bank of Ireland on Mortgage Arrears and Repossessions Statistics for the third quarter of 2012.



October and 1.8% in July) and comfortable bid-to-cover ratios. The increased market appetite likely reflects the continuously strong program implementation and progress on European initiatives to strengthen the institutional architecture of EMU. These issuances enabled a significant increase in cash balances, which stood at EUR 23.4 billion at the end of September (see also Table 3 on page 45), with corresponding upwards revisions to the interest bill and gross debt.

**Figure 8: Developments on the Irish government bond market**

*Irish bond yields have declined steadily in 2012... ...while ratings have stayed flat.*



Source: Bloomberg, Fitch and S&P.

### 3. Programme implementation

#### Programme implementation remains strong

- Fiscal policy/framework.** Cash figures through September showed a better-than-profiled central government balance (the IMF quantitative performance criterion on the cumulative primary exchequer balance for Q3 has been met by a sizeable margin, i.e. EUR 1.3 billion). Two Bills were published as per the programme requirement. The Fiscal Responsibility Act<sup>9</sup> places the Irish Fiscal Advisory Council on a statutory basis and implements budgetary rules and debt rule in line with the Treaty on Stability, Co-ordination and Governance in the Economic and Monetary Union. The other piece of legislation will provide legal basis for already operational medium term expenditure ceilings (Ministers and Secretaries (Amendment) Bill 2012)<sup>10</sup>. Health measures were specified to address the health overruns, although their implementation and effectiveness was not as anticipated (see section 5 below).
- Financial sector reforms.** In recognition of the progress achieved towards the programme's deleveraging objectives discussed in section 2, the modified deleveraging monitoring framework<sup>11</sup> has been formally operationalised through official communications by the central bank to covered institutions, and the first report under the

<sup>9</sup> <http://www.finance.gov.ie/documents/pressreleases/2012/mn109append.pdf>

<sup>10</sup> <http://www.oireachtas.ie/documents/bills28/bills/2012/8112/b8112.pdf>

<sup>11</sup> Described in the [report](#) on the 7<sup>th</sup> programme review (see, e.g., page 25).

new monitoring arrangements was provided in accordance with programme requirements. The authorities have also provided their routine reports on banks' performance with the work-out of arrears and unsustainable mortgage and SME loans. The financial supervision framework continues to be updated. In line with programme requirements, two pieces of legislation were published to (i) strengthen the credit union legislative framework and (ii) establish a Central Credit Register. Further benchmarks were observed through the introduction of regulations to (i) require credit unions to maintain an amount in the Deposit Protection Account of the CBI and to (ii) institute a credit institution resolution levy to recoup EUR 500 million in Exchequer resources provisioned for the resolution of troubled credit unions. The latter is, in some key respects (notably, the basis of the levy and the target size of the resolution fund), not fully in line with the European Commission's proposal for the EU directive establishing a framework for the recovery and resolution of credit institutions and investment firms, and the authorities have undertaken to review it when the EU legislation is published. Individual banks' operational reorganisations also continue to progress, with an updated restructuring plan submitted by AIB's management to the European Commission for assessment under state aid rules.

- **Structural reforms.** Legislation reforming sectoral wage setting arrangements to increase labour market responsiveness to changing economic conditions was enacted in July, and the authorities have updated the Troika on the actions they are taking to strengthen their labour market activation policies, including in terms of data collection and provision (progress is being made, but the challenge is enormous and efforts could be stepped up accordingly, see section 7). A programme facilitating access to professional financial advisory services for distressed borrowers was put in place. Finally, progress continued in terms of bringing identified non-strategic state assets closer to the point of sale and detailing the implementation strategy for the reform of water services, although delays to the latter appear to be accumulating, especially as regards the metering programme (see section 7), and implementation risks correspondingly growing.

**New conditionality milestones were agreed, and an existing financial sector benchmark was postponed by a quarter.** New programme conditionality was introduced including to guide the process leading to the introduction of water charges, to monitor closely the banks' progress on resolving longer-dated arrears, to amend the Company act making for cheaper and easier debt resolution processes for SMEs, to assess the costs of health service provision in comparison with other countries, and to ensure that the new personal insolvency framework operates amid balanced incentives by restoring banks' ability to repossess their collateral as an appropriate last resort measure. Taking account of recent developments concerning the EBA stress test, now expected in the second half of 2013, and given prior understanding that the two exercises would be aligned in terms of timing, it was agreed to postpone the programme requirement to complete the next PCAR from the second to the third quarter of 2013 (see updated programme documents in Annex 3).

#### 4. Macroeconomic outlook

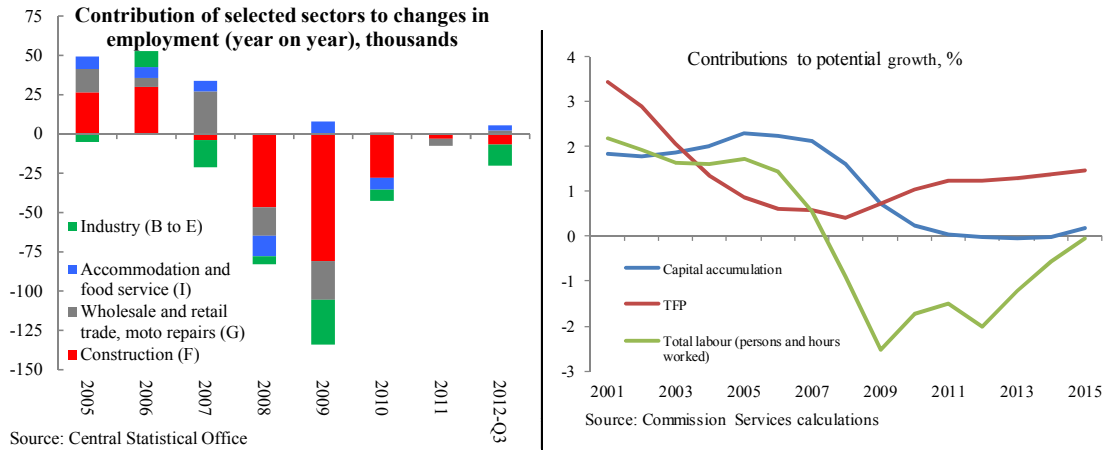
**The growth forecast underpinning the programme remains unchanged for 2012, albeit with a slightly different composition, but it has been revised down for 2013.** The overall growth story for the coming years is unchanged, with net exports as the main driver of growth, although domestic demand is expected to be slightly weaker than

previously assumed. As outlined earlier, data released since the seventh review continue to be broadly consistent with real GDP growth of 0.4% in 2012. The contributions from net exports have been revised up somewhat for 2012-2013, however, mainly due to imports recently being weaker than expected. Private consumption has accordingly been revised down marginally for the coming years. Export projections for 2012 have been kept at previous levels despite the worsening external environment. For 2013 the downgrade of the external environment projections compared to the seventh review is expected to bring down export growth somewhat, although the resilience of exports (particularly services) in recent years will likely act as a buffer. A gradual slowdown of growth in goods exports as patents expire is built into the projections, as well as more modest growth rates of services exports than what has been observed recently. The contribution to growth from net exports is set to stay largely unchanged as further contractions are expected across all domestic demand components, which will dampen imports correspondingly. As a result, 2013 GDP growth has been revised down to 1.1% from 1.4% at the seventh review.

**The outlook for nominal GDP growth in 2013 is, however, broadly unchanged.** The HICP inflation forecast has been revised up to 2.0% for 2012 following relatively strong increases earlier in the year (even after taking the recent moderation into account). Inflation is expected to decline in the coming years as temporary price pressures are unwound, thus supporting continued gradual improvement in competitiveness relative to the euro area, before inching up again towards 2% by 2015 in line with expected developments in the euro area. Although recent terms-of-trade developments have partly offset the effects of higher inflation on the GDP deflator, the net effect is positive, which results in higher projected levels of nominal GDP in 2012-2013 compared to those underpinning the 7<sup>th</sup> review despite the lower real GDP growth rate in 2013.

**Weak labour market developments and their knock-on effects on domestic demand are expected to weigh on real GDP growth into 2014.** The anatomy of the shock to the labour market has been outlined in previous reports—massive job losses both in the construction and industrial sectors being followed by loss of services jobs (Figure 9)—but recent data again suggest that previous projections were somewhat optimistic as regards to when employment would start growing and unemployment fall substantially. As a result of weaker labour market projections, domestic demand and GDP growth for 2014 have also been reduced. Since the start of the crisis, potential growth has been driven solely by total factor productivity amid extensive labour shedding and extremely low levels of investment, in marked contrast to the prior period (Figure 9). The mission continues to believe that the Irish economy has the potential to grow around 3% per year towards the end of the projection period, although the continuous edging up of the share of long-term unemployed, the risk of cemented skills mismatches and the uncertain investment outlook are increasing threats to that assessment.

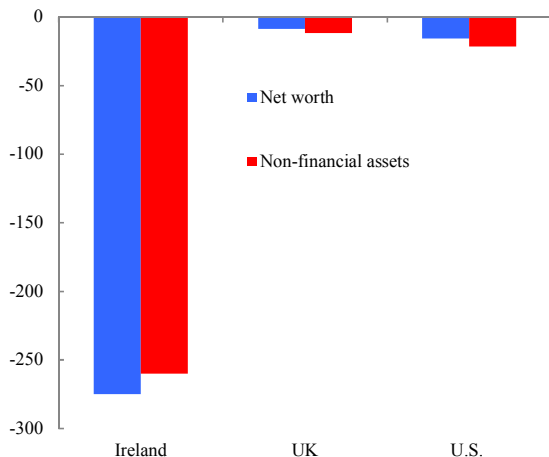
**Figure 9: Labour market and contributions to potential growth**



There is significant uncertainty around domestic demand projections from the private sector debt overhang and high precautionary savings, and possible profit-hoarding by some corporates. Property markets have just started to show signs of stabilisation and substantial deleveraging has so far hardly dented the elevated household debt to disposable income ratio, which at 200% is more than twice the euro area average. The link between mortgage payment discipline and labour market status is also strong according to a recent CBI survey. These are the factors underpinning the baseline scenario where balance-sheet adjustment due to the large hit to household net worth (see Figure 10) will continue to weigh on domestic demand. On the upside, positive surprises relative to the baseline could result from the unwinding of precautionary savings, which appear to be very significant at least among those cohorts (loosely, the very young and old—see Figure 10) where many households are without mortgages. Such unwinding of precautionary savings could unleash substantial pent-up demand once macroeconomic uncertainty dissipates or bequests are realized.

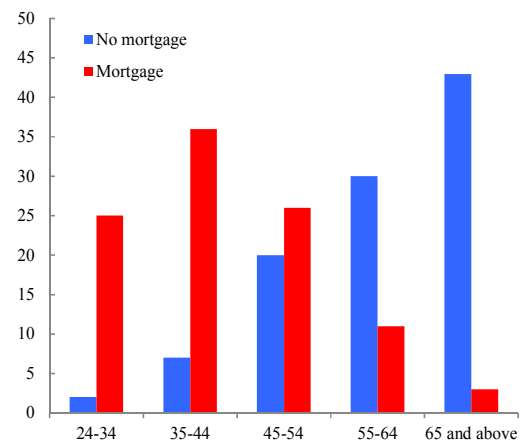
**Figure 10: The wealth effect of the housing bust, aggregate and by cohorts**

*Change in net worth and non-financial assets as percent of nominal disposable income, 2007-2012*  
1/



1/ Last observation Q4 2010 for U.K. and U.S.  
Source: OECD, Goodbody.

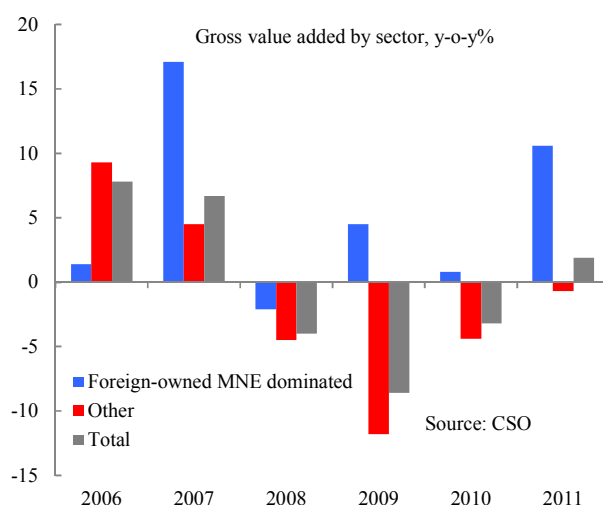
*House ownership by cohort*



Source: CSO

**The non-financial corporate sector is not yet playing a growth-supporting role in line with its potential.** Profit shares are back to pre-crisis levels and continue trending upwards, although their macroeconomic importance is difficult to assess due to transfer pricing issues by multinationals (which account for the bulk of growth in gross value added (GVA) in recent years, see Figure 11), and the partial decoupling of value added in the sector from aggregate employment and other domestic developments. Debt ratios have stabilized at twice the euro area average and investment rates continue to decline. Credit constraints, which appear to be especially binding for SMEs, are likely an important explanatory factor for the subdued credit growth, but so is the lack of confidence in future growth prospects.

**Figure 11: Gross value added by sector**



Source: CSO

**The authorities expect somewhat stronger real GDP growth.**<sup>12</sup> The Department of Finance is more optimistic on GDP growth than Commission services throughout the 2012-2015 period, with an annual average difference of 0.3 percentage points. This results in its projected level of nominal GDP being EUR 1.5 billion higher by 2015 despite very similar projections for the GDP deflator. The main drivers of the difference are larger contributions from domestic demand, especially through lower imports and higher investments, as well as somewhat stronger export developments. The differences on the labour market side are minor, with the Department of Finance projecting slightly stronger employment growth in 2012-2013.

<sup>12</sup> See the [Budget 2013, www.budget.gov.ie](http://www.budget.gov.ie), published in early December.

**Table 1: Revised macroeconomic framework**

	Eight review forecasts (latest)					Seventh review forecasts (previous)				
	2011	2012	2013	2014	2015	2011	2012	2013	2014	2015
	% change on previous year (unless otherwise specified)									
Real GDP growth	1.4	0.4	1.1	2.2	2.8	1.4	0.4	1.4	2.5	2.8
Private consumption	-2.3	-2.1	-0.5	1.2	1.8	-2.4	-1.9	-0.2	1.4	1.9
Public consumption	-4.3	-4.0	-1.7	-3.0	-3.3	-4.3	-3.0	-0.7	-3.5	-3.4
Fixed investment	-12.2	-4.0	-1.5	3.0	5.2	-12.6	-4.0	-0.1	4.5	5.2
Domestic demand (contribution)	-3.4	-2.2	-0.7	0.3	0.8	-3.4	-1.9	-0.2	0.5	0.9
Inventories (contribution)	0.4	0.0	0.0	0.0	0.0	0.4	0.0	0.0	0.0	0.0
Exports	5.1	2.8	3.2	4.2	4.5	5.1	2.8	3.5	4.5	4.5
Imports	-0.3	0.3	2.0	3.2	3.6	-0.3	0.8	2.5	3.5	3.6
Net trade (contribution)	5.4	2.6	1.8	1.9	2.0	5.4	2.3	1.6	2.0	2.0
Employment	-2.1	-1.2	0.0	0.9	1.9	-2.1	-0.8	0.4	1.3	2.0
Unemployment rate (level)	14.4	14.8	14.7	14.2	13.4	14.4	14.8	14.4	13.7	13.1
GDP deflator	0.2	1.7	1.3	1.4	1.6	0.2	1.4	1.2	1.4	1.6
HICP inflation	1.2	2.0	1.3	1.4	1.6	1.2	1.4	1.0	1.4	1.6
Current account (% of GDP)	0.5	2.3	3.4	4.4	4.5	1.1	2.1	3.3	4.6	4.7
Nominal GDP (EUR billion)	159.0	162.3	166.2	172.3	179.9	159.0	161.8	166.1	172.7	180.5

Source: Commission services' calculations.

## 5. Policy discussions

### 5.1 Fiscal policies

*Putting fiscal policy gradually back on a sustainable base is a key objective of the programme. The authorities continue to make good progress in this respect, having met so far all the quarterly fiscal targets under the programme. Yet much still remains to be done—including to address new spending pressures, e.g. in the health area—to close the still large fiscal deficit, and ensure that the debt ratio peaks next year and then embarks on a declining path. The key challenges will be to ensure that the adjustment is as growth-friendly as possible and does not prejudice the quality of public services and that its burden is fairly allocated (the most vulnerable should be shielded as much as possible). The fiscal framework continues to be strengthened, and the legislation granting statutory basis to the multi-year expenditure ceilings should ensure that these act as a credible anchor for policies and expectations after the programme period.*

**The 2012 budget deficit ceiling is estimated to have been observed.** The draft 2013 budget forecasts the deficit for 2012 at 8.2% of GDP, below the 8.6% programme ceiling. Despite weaker revenue in the fourth quarter, and expenditure overruns in health and social welfare, the programme's deficit ceiling is envisaged to be respected thanks to a one-off higher-than-budgeted revenue from UMTS licence sales, lower-than-planned debt servicing costs, savings in the capital budget and the positive effect of the higher nominal GDP base.

**There have been overruns in the health sector, which require durable reforms to reduce the risks of future spending pressures in this area.** In July the authorities

announced a set of measures to offset the health overruns. They committed to deliver at least part of the savings for items planned in the 2012 budget and to take additional structural measures addressing spending pressures (see [report](#) on seventh<sup>h</sup> review). Discussions during the mission evidenced that those commitments have been only partly implemented, resulting in an estimated overrun of EUR 370 million through November 2012. Combined with additional spending pressures by year-end and the unwinding of temporary measures next year, the structural gap in the health vote is about EUR 700 million (see Table A1 in Annex 2).

**To deal with this problem, the authorities presented a package of measures in the 2013 budget.** The total effort addressing the 2012 overrun and ensuring the planned adjustment in 2013 amounts to EUR 780 million. The package includes already announced and new measures. The former include the October 2012 deal with the pharmaceutical industry (expected to yield savings of about EUR 145 million), further exploiting the scope for flexibility arrangements under the Croke Park Agreement and additional pay savings (EUR 308 million), and charging all private patients in public hospitals (EUR 65 million). The new structural measures under the Primary Care Reimbursement Service (PCRS) (EUR 163 million) include reducing fees payable to health professionals (EUR 70 million), tightening eligibility criteria and greater co-payments<sup>13</sup> (estimated to generate savings of EUR 90 million).

**The mission stressed that the chosen measures must be swiftly and fully implemented in order to meet the estimated saving targets.** Based on 2012 budget experience, the identified measures are subject to significant implementation risks mainly related to the delays in publishing the necessary legislation. This is the case, for example, for the provisions to charge all private patients in public hospitals, which is to be adopted by end 2012 and for which a clear implementation timeline is not yet available. The authorities have also begun an engagement with unions representing public servants, including health sector workers, to seek additional savings from the public service pay and pensions bill, along with additional productivity reforms (including in terms of hours worked). The mission took the view that all options should be kept on the table and that additional savings in the public sector paybill should be made in a manner that does not compromise the delivery of key public services, including the option to review pay scales and allowances besides relying on further reductions in payroll numbers.

**Moreover, the mission pointed out that significant scope remains to increase the efficiency, cost-effectiveness, monitorability and sustainability of the health system,** including by implementing key reforms announced in the 2012 annual output statement for health expenditures. These include, for example, the introduction of a unique patient identifier, the enhancement of primary care reimbursement services, the expansion of general practitioners' (GPs) after-hours services, fuller cost recovery of the costs of treating private patients in public hospitals, and the introduction of a financing mechanism based on the "*money-follows-the-patient (MFTP)*" principle to foster integrated health care, better cater health service provision to individual needs, increase transparency and improve cost control. The rationalisation of the hospital network can be

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<sup>13</sup> Main savings stem from: increasing prescription charges for medical card holders (EUR 51 million); tightening restrictions on medical card eligibility (EUR 20 million); adjusting the income eligibility threshold for medical cards for over 70s to replace medical cards with GP-only cards (EUR 12 million); and increasing the Drug Payment Scheme (DPS) threshold (EUR 10 million)

speeded up and the drugs bill reduced further (Ireland currently spends 34% more in per capita terms than the EU average – Figure 12 in Box 1), including by promoting greater use of generic drugs and ensuring that they are procured at prices more in line with other jurisdictions, and further advancing towards performance budgeting and its integration with budget planning procedures. A key enabler of cost reduction would be a system of compulsory prescription by active ingredients and generic substitution from pharmacies, combined with regular monitoring of doctors' prescription behaviour to check their compliance with binding prescription guidelines. To ensure that outpatient pharmaceutical spending does not exceed the available annual financial envelope in the budget, the government could also consider putting in place a claw-back mechanism (i.e. a rebate to be charged on pharmaceutical companies on a quarterly basis), in line with practice in other Member States. A cost allocation formula/mechanism should be set up to ensure full recovery, from specialists and insurance companies, of the costs to the State arising from private fee-for-service practices carried out in public hospitals. Finally, the Government could review the fees and salaries paid to medical professionals (see Figure 14 in Box 1), increase co-payments for products and services, and tackle the unsustainable growth in medical cards, including through greater use of GP Visit Cards to substitute for more expensive medical cards.

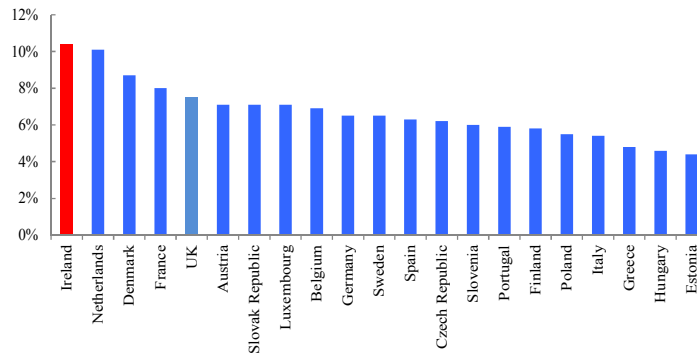


## Box 1: Maximising efficiencies to achieve better health outcomes

### Improving value for money is key

While most indicators show Ireland close to average in terms of health outcomes, health spending, especially on a per capita basis, is relatively high, suggesting poor value for money (Figure 12). In the period 1997 – 2007, per capita increases in healthcare spending in Ireland outpaced almost all other OECD countries. In a 2010 report, the OECD found that Ireland had the greatest potential for efficiency savings in public healthcare spending, and that the potential gains in life expectancy which could result were the second highest in the OECD.

**Figure 12: Health spending as a proportion of national income (2010)**



Source: Paul Redmond (2012) *Expenditure and Outputs in the Irish Health System: A Cross Country Comparison*; publicpolicy.ie. The data are adjusted to take account of a countries proportion of over-65s. For Ireland, national income is measured using GNI; for all other countries it is GDP.

As discussed in Section 5, the immediate focus for health policy is on achieving budgetary targets. But many of the factors behind the overruns (e.g., staffing costs, drugs spending) are also linked in the medium term to improving efficiencies. Raising the efficiency of spending towards EU benchmarks should allow for improving outcomes for patients over time while containing the level of spending.

### Better measurement is a first step

A key first step is to put in place better measurement systems that are a) monitorable, b) internationally comparable and c) patient-focused. Within this context, the pilot Government-level performance measurement system under the [Public Service Reform Plan](#) (linking Government's high-level goals to outcomes and outputs) could be expanded to include Health, as originally planned.

### More could be done on the cost of Pharmaceuticals

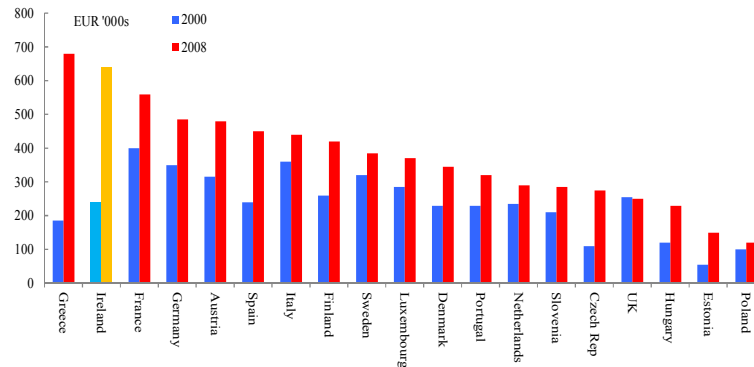
While all EU countries have seen substantial increases in drugs costs since the turn of the century, Ireland's increases have been among the sharpest, nearly tripling from 2000 to 2008 (Figure 13).

In 2010, per capita spending on pharmaceuticals in Ireland was the highest in the EU, 34% above the average, while health outcomes are not better than the average for EU countries over a range of high-level indicators. This suggests a potential for savings well beyond the measures already announced.

High drug prices is an important factor. In particular in the area of generics, prices of the same drugs vary considerably across EU Member States, and with the patents on many branded drugs approaching expiration (the so-called 'patent cliff'), renewed attention could be paid to maximising the benefits of lower cost generics. Cost savings from generics are greatest when the uptake follows quickly from patent expiry. Important savings could be achieved with a reform of the external reference pricing mechanism. At present, Ireland sets prices for drugs based on an average of a basket of reference countries. Significant gains could be made by: (i) expanding the set of countries in the reference list and (ii) moving benchmarks from the average to the lowest prices among reference countries. On the demand side, prescription by active ingredient rather than by name of drug (with exceptions allowed only for "non-substitutability" cases to be rigorously motivated by the prescribing doctor), electronic monitoring and financial incentives could be employed to ensure prescribers are seeking the most cost effective alternatives. Provisions to these effects would significantly increase the efficiency-enhancing effects of the (Pricing and Supply of Medical Goods) Bill 2012. The switch to prescription on the basis

of International Nonproprietary Name (INN), where possible, will facilitate compliance with the forthcoming Implementing Directive designed to help recognition of prescriptions issued in another member state, which all Member States must transpose by 25 October 2013.

**Figure 13: Total pharmaceutical expenditure per capita (2010)**



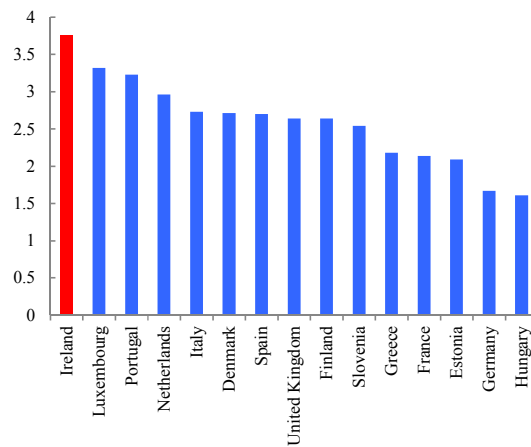
Source: OECD Health Data 2010

**Remuneration of medical staff should also be reviewed**

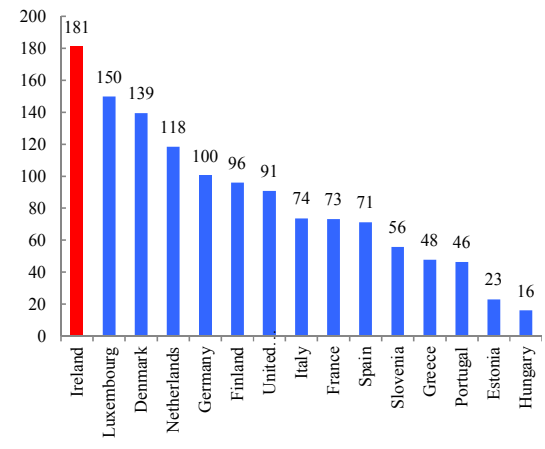
The high level of remuneration of doctors, in particular specialists, is another feature of Irish health spending which may warrant attention. OECD data show that Ireland's remuneration to medical specialists is well above the EU average (although some caution is required in making cross-country comparisons).

**Figure 14: Salaries of medical specialists in some EU countries**

*As a ratio of average wage*



*In EUR thousands*



Source: OECD Health Data 2012. Data are for 2010 except Estonia, Italy, UK and Ireland (2011); Germany (2012); Luxembourg (2005); Netherlands and France (2009); Portugal (2005). Source: For Germany, average of three increments for 2012, Grade A 4 (Western Germany only); for all other countries: OECD Health Data 2012. Data are for 2010 except Estonia, Italy, UK and Ireland (2011); Germany (2012); Luxembourg (2005); Netherlands and France (2009); Portugal (2005).

The authorities indicated that negotiations between the Department of Health / HSE and Hospital Consultants to achieve more efficiency from existing contractual arrangements have been recently completed and that the pay rate for newly appointed specialists will be cut by 30%. A comprehensive review of the market for medical staff could be considered, however, a some of the problem may lie in the low number of specialists as a proportion of all doctors. There may be value in strategies to further open the supply of labour to suitably qualified specialists from other countries. For instance, from 2007 to 2011, Ireland recognised 151 intra-EU qualifications for doctors (per million inhabitants); for the UK it was 205 per million inhabitants. For doctors wishing to set up practice in Ireland, such recognition is a precondition. Outside the EU, even more potential exists to open labour supply; however, it is important that Ireland observes standards from the WHO's ethical recruitment code when

pursuing recruitment from developing countries.

**The 2013 budget targets a deficit of 7.5% of GDP – in line with the programme's deficit ceiling.** While the previously announced aggregate consolidation commitment of EUR 3.5 billion in 2013 has not changed, its composition has shifted slightly more to revenue measures compared to the MTFS projections<sup>14</sup>: EUR 1.9 billion in expenditure and EUR 1.4 billion in revenue measures, as well as increased dividends from state-owned companies of EUR 0.1 billion. Earlier introduction of the property tax in mid-2013 has some effect on the split between new revenue measures and carry-overs. The valuation-based property tax is expected to yield EUR 250 million in 2013, when it will be assessed only on a half-year basis, and EUR 500 million on a full year basis. Additional revenue on accrual basis is expected from the property tax deferral option for asset-rich but income-poor households.<sup>15</sup> Other major revenue measures include the broadening of the base for social contributions (PRSI, yielding EUR 286 million), and increases in excise duties on alcohol and tobacco (EUR 205 million), as well as in the motor and vehicle registration tax (EUR 150 million).

**The expenditure plans for 2013 are broadly consistent with an expenditure ceiling of EUR 54.3 billion.** The reduction of EUR 1.7 billion in the gross voted current and capital expenditure from the 2012 level reflects expenditure saving measures of EUR 1.9 billion in an environment of increasing demand for social services, including unemployment benefits, education and health care. Current expenditure adjustment amounts to EUR 1.4 billion and capital to EUR 0.5 billion. The current expenditure measures include cuts in child benefit rates (EUR 136 million), further reduction in the public service paybill, including through reductions in the number of public sector employees (EUR 220 million), increase in student contributions, many smaller savings across the government departments, and measures to contain health-care costs (see above).

**The authorities have also reiterated their commitment to bringing the government deficit below 3% of GDP by 2015.** The adjustment effort for 2014-15 remains largely unchanged, as well as previously outlined broad consolidation measures, yet details on specific measures are not available. On the basis of the Commission services' lower macroeconomic projections, the planned adjustment effort over the forecast period may not be sufficient to reach the deficit targets. A new Comprehensive Expenditure Review will start in 2013 providing options for further fiscal adjustment in 2014-15 and reassessing government spending priorities.

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<sup>14</sup> Higher revenue projections include temporary non-tax revenues from bank guarantees, central bank profits and profits of state-owned enterprises which make up for lower-than-previously-expected tax revenues.

<sup>15</sup> Appropriate accounting treatment of the property tax deferral will be determined by the statistical authorities.

**Table 2: Fiscal adjustment commitments 2013-2015, EUR billion**

	2013	2014	2015
Permanent consolidation measures	3.5	3.1	2.0
of which new measures	3.2	2.5	1.8
Revenue	1.43	1.1	0.7
<i>First year effect</i>	<i>1.21</i>	<i>0.5</i>	<i>0.5</i>
<i>Carryover from the previous year</i>	<i>0.22</i>	<i>0.6</i>	<i>0.2</i>
Expenditure	1.94	2.0	1.3
<i>Current</i>	<i>1.44</i>	<i>1.9</i>	<i>1.3</i>
<i>Capital</i>	<i>0.5</i>	<i>0.1</i>	<i>0.0</i>
Increased dividends (temporary)	0.1		

Source: Budget 2013 and MTFS.

**Public service reforms are ongoing.** The implementation of the Public Service (Croke Park) Agreement 2010-2014 is progressing. According to the Implementation Body's Second Annual Progress Report, a substantial reduction in staff numbers (around 11,530) took place during the review period (April 2011-March 2012). As of mid-2012, public service numbers were 292,000, i.e. 28,000 below the peak of 320,000 in 2008 and comparable to 2005 levels. The Exchequer pay bill has been reduced by 17.7% in nominal terms between 2009 and 2012 (18.7% in real terms), from EUR 17.5 billion (gross) to EUR 14.4 billion (net of the pension-related deduction), while the Exchequer pension bill has increased by 15.4% from EUR 2.6 billion (gross) to EUR 3 billion (gross).<sup>16</sup> The Implementation Body estimated that, during the first two years of the agreement, pay and non-pay savings of EUR 810 million and EUR 678 million were achieved, respectively. Over the period 2009-2015, the annual Exchequer pay bill is expected to fall by EUR 3.8 billion, or by EUR 3.3 billion net of expected increases in public service pension costs. The mission stressed once again the need to closely monitor the implementation of the agreement in order to ensure that the desired savings are achieved, and that all options should be kept on the table to ensure that the delivery of essential public services is not compromised. Furthermore, the mission reiterated that reductions in allowances and salary scales for some categories of workers could be considered as a way to better align pay rates with those other countries. This would also allow further savings in the pay bill to be made without compromising the delivery of essential public services. This is especially the case in the health sector where, as underlined by a recent WHO report,<sup>17</sup> substantial additional savings through efficiency

<sup>16</sup> The pay bill had increased very sharply in the pre-crisis period. Data from various issues of the Analysis of Exchequer Pay and Pension Bill (2000-2005; 2006-2011; and 2007-2012) show that, between 2000 and 2008, the Exchequer Pay and Pension Bill increased by 118% from EUR 8.9 billion (gross) to EUR 19.4 billion (gross) and by 117% from EUR 8.6 billion to EUR 18.7 billion (net). As a percentage of GDP (GDP), it increased by 2 (2.3) pp from 8.4% (9.8%) to 10.4% (12.1%). See also Box 2 below.

<sup>17</sup> *Health system responses to financial pressures in Ireland: policy options in an international context*, [http://www.dohc.ie/publications/pdf/Observatory\\_WHO\\_2012.pdf?direct=1](http://www.dohc.ie/publications/pdf/Observatory_WHO_2012.pdf?direct=1)

gains cannot be made within the required timeframe without damaging patient care<sup>18</sup> unless high salaries and the high price of other inputs are seriously addressed.

**The authorities have announced just before the eighth review mission a targeted voluntary redundancy scheme which they consider would facilitate meeting the 2015 target for public service staff numbers of 282,500 by 2014.** The scheme would be made available for yet-to-be-identified public service areas with staff surpluses. The terms of the scheme are as offered to HSE employees in 2010, namely a statutory payment (2 weeks per year of service, with the per-week payment capped at EUR 600, plus an additional EUR 600) and an incentive payment (3 weeks per year of service), subject to an overall cap of two yearly salaries. The authorities argue that it would allow a substantial structural improvement in the deficit, in terms of payroll and pension savings, and that it will pay for itself in 3 years. Their stated objective would be to secure long-term structural adjustments by targeting groups of employees for whom they believe redeployment and training would not be cost-effective.

**The mission considers that the scheme is costly** and that using in full the scope for redeployment and retraining under the Croke Park agreement would allow a more efficient use of human and financial resources, especially as the scheme's intended target group of employees has considerable remaining working life. In addition, there is a real risk that the scheme fails to reach the intended target, as employees that have few outside options choose not to separate. Moreover, while the scheme would generate savings in the longer term (as less pension rights would be accrued), it is likely to imply additional cost pressures for the welfare budget in the near term. Finally, the extent to which the scheme would be compatible with protecting service delivery or would require outsourcing of activities is unclear, casting doubts on the sustainability of the estimated savings.

**Full implementation of pension reform is a crucial component of long-term sustainability of public finance.** The Public Service Pensions (Single Scheme and other provisions) Act 2012 came into effect on 28 July 2012. The Act caps, for existing members as of 1 November 2012, pension accrual at 40 years, abates the pensions of public service pensioners who re-enter the public service, and allows for money to be recovered from pension payments in certain cases of financial misconduct. Yet important provisions for new entrants, such as the increase in the pension age and the calculation of the pension on average lifetime income, have yet to be put in place, pending a commencement order to be signed by the Minister of Public Expenditure and Reform. Delays in the commencement of the scheme imply a permanent reduction in the structural savings in terms of pension liabilities. The mission sought an update on the process and the authorities confirmed that the bill should be fully commenced by 1 January 2013.

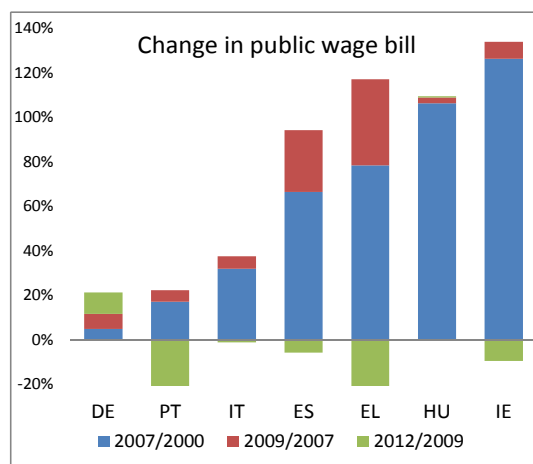
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<sup>18</sup> From this perspective, the envisaged 3,000 employee number reductions under the health sector Employment Control Framework (EFC), is a source of concern, as it could lead to service delivery pressures, besides resulting in higher agency/overtime costs which could offset the expected savings.

### Box 2: A significant unexplained wage gap between public and private sector wages?

Ireland's public service pay and pension bill grew sharply in the pre-crisis years through a combination of pay rises and increases in public service employment (Figure 15). The authorities cut public sector wages between 5% and 15% effective 1 January 2010 and introduced a pension-related deduction in 2009, with rates ranging from 0% to 10.5% depending on the income bracket. This resulted in a fall in average annual (gross) earnings in the public service by 7.5% between 2009 and 2010 (in the same period, the fall for private sector workers amounted to 4.5%). Since then, in line with the Croke Park agreement, there have been no further reductions in pay rates.

Figure 15: Changes in public wage bill



However, a recent study by the Central Statistics Office (CSO)<sup>19</sup> has found that a sizeable positive gap remains between public and private sector wages that cannot be explained by worker or workplace characteristics. The analysis takes account of educational attainment, gender, full-time status, total length in employment and supervisory status. Although the study does estimations for wages both with and without employer size taken into account, the CSO did not control for specific occupations/job types across the two sectors. The study covers 2009 and 2010 (i.e. the year of the wage cut), although 2010 data could only be derived from the 2009 National Employment Survey by using data on net incomes from the Revenue Commissioner. The pension-related deduction of 2009 is also excluded from the analysis, which applies to gross earnings.

In spite of the academic debate surrounding the methodology,<sup>20</sup> the CSO analysis points out that a significant unexplained wage differential in favour of public sector workers persists, even following

<sup>19</sup> CSO (2012). National Employment Survey 2009 and 2010. Supplementary Analysis.

<sup>20</sup> Several issues have been raised in Ireland and in academic papers as regards the methodology of the study, in particular because of the inability to control for specific occupations (a number of low-skill jobs in the private sector do not exist in the public sector) and because of the difficulty to properly control for organisational size. On the latter, the CSO opted to use a wide definition of the employer in the case of the public service. For example, all secondary school teachers are assumed to belong to one single "national entity", rather than a smaller school-level one. To a certain extent, the size indicator therefore becomes a close proxy of public sector vs. private sector. Moreover, since large multinational companies in the private sector pay high wages, wages in the public sector in a specification that controls for "size" of the employer and lumps all teachers together as having a single very large employer would be predicted to be higher just by this association, which is erroneous. The CSO sought to address this problem by providing results both with and without controlling for size.

<sup>21</sup> [ECB working paper 1406 \(December 2011\)](#) finds a conditional wage premium in favor of public sector employees in a range of countries, with Ireland displaying a relatively high premium. This study only covers the period 2004–2007, however, i.e. before the public service pay cuts in Ireland.

the pay cuts of 2010.<sup>21</sup> The analysis shows that the unexplained wage gap for permanent full-time employees (aged 25-59) was around 14-17% in 2010, down from 18-20% in 2007, if employer size is not factored in. Including size, with the caveat highlighted above, reduces the gap to around 7-8% in 2010, down from 12-14% in 2007. Further analysis indicates that the unexplained wage gap is highest at the low-income end of the distribution, and gradually falls to nil or negative (depending on whether size is included as a control variable) around the 80th or 95th percentile in 2010. In 2009, the gap remained positive throughout the income distribution.

**The mission also discussed ongoing reforms of the public expenditure framework.** As mentioned above, two Bills were published in the third quarter of 2012 to establish the Irish Fiscal Advisory Council as an independent body on a statutory basis and define its mandate and responsibilities, as well as enshrine its independence, and to provide a statutory basis to the existing multi-annual expenditure ceilings. As regards the latter, the Commission's services are engaging with the authorities to ensure that elements of the multi-annual budgetary framework are adequately binding and transparent so as to constitute a credible policy anchor in the post-programme period. While three-year rolling expenditure ceilings are envisaged under the domestic budgetary framework, the government has not committed to the expenditure ceilings for 2015 in the current budget, before the Comprehensive Expenditure Review in 2013.

**Further improvements are necessary to the legislation on expenditure ceilings to ensure that the framework constitutes a credible anchor for fiscal policy (Box 3).** Based also on the results of a comprehensive review of the national fiscal frameworks of all EU Member States carried out under the auspices of the Economic Policy Committee (EPC) during 2011-2012, Commission services and ECB pointed out that the current draft does not sufficiently narrow down the conditions under which the Government may evoke an escape clause and thus be allowed to diverge from expenditure ceilings. Rather, the Government enjoys significant latitude to increase the ceilings without adequate accountability, as it only requires a proposal of the Minister for Finance. Moreover, the current draft does not provide sufficient assurances that the current and capital expenditure ceilings are met in practice, since the Minister for Finance may only make recommendations to the competent Ministers but is not actually empowered to impose binding ceilings. The mission also noted that the *de-facto* current fiscal rule requiring local governments to have a balanced budget in the aggregate could be firmed through a binding act (e.g. a memorandum of understanding) ensuring that local authorities' contribution to general government will be held to zero as a rule as of 2013.

**The provision of fiscal data has been improved, and efforts in this area continue.** The CSO will be in charge of the EDP reporting as of March 2013 and will publish a quarterly government finance statistics publications from April 2013. To ensure more reliable and transparent public finance data, the authorities are working on a memorandum of understanding on data exchange between the competent authorities. The authorities published for the first time, at the end of September, an alternative presentation of the Exchequer Returns, which enhances budgetary reporting and transparency by showing voted expenditure (current and capital, including spending from departments, the Social Insurance Fund, and the National Training Fund) and all revenue (current and capital, including separately the monthly outturn for Appropriations-in-Aid) *on a gross basis*. Further efforts have to be made to complete the new format by reporting on all major Exchequer items, as compared to monthly targets. This will be an important step to further increase the credibility of the budgetary framework and will facilitate

access to and understanding of the fiscal data for prospective investors and the public at large, especially after the end of the programme.

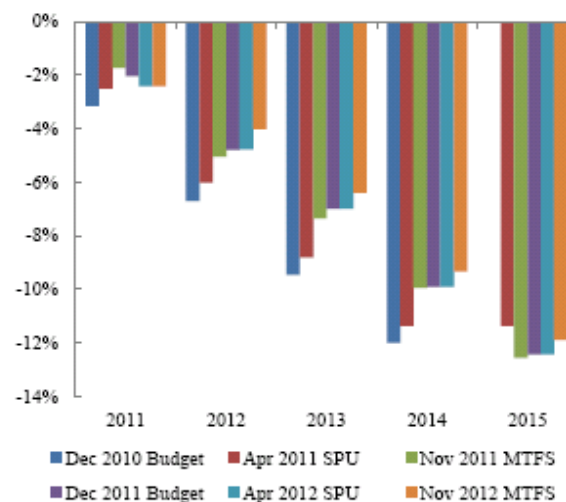
**Box 3: Experience with expenditure ceilings under the programme**

The programme, which was largely based on the Irish authorities' 2010 National Recovery Plan, targeted a very significant reduction in *nominal* expenditure relative to their 2010 level as a key component of the necessary fiscal consolidation. This was underpinned by the multi-annual expenditure ceilings for gross voted expenditure introduced on administrative basis.<sup>22</sup> Much has been achieved in this respect, with 2012 gross voted current expenditure expected to be 4% lower than in 2010 (Figure 16).

Alongside these significant cuts, a closer look reveals gradual slippages with respect to original annual targets on account of (i) changed macroeconomic conditions (e.g., greater number of people on the live register) and (ii) policy implementation (e.g., delayed/failed implementation of planned measures in health area).

**Figure 16: Reductions in gross voted expenditures, outturn vs. targets**

Reduction in gross voted current expenditure from 2010 level –outturns vs targets as per expenditure ceilings



Note: Expenditure ceilings are adjusted for the change in composition of fiscal adjustment introduced with the 2011 MTFS, which postponed part of the adjustment in current expenditure to outer years.

While the expenditure slippages vis-à-vis original targets have not impeded the achievement of the programme targets and, thus, the establishment of a track record of good policy implementation under the programme as regards the general budget balance to GDP ratio, they shift the burden of the remaining expenditure adjustment up to 2015 as the ceilings for 2015 have actually been tightened compared to 2010. It is important to ensure that the on-going reforms of the multi-annual expenditure framework result in more binding and specific rules for expenditure ceilings, so that they can act as a credible policy anchor especially for the post-programme period.

<sup>22</sup> Gross voted current and capital expenditure cover large share of the total government expenditure and are under direct control of the government. They exclude non-voted expenditure, e.g. interest expenditure and EU budget contributions.



## 5.2 Financial sector policies

*Important progress has been achieved across the three main components of financial sector reform under the programme: banks are well-capitalised, system deleveraging is ahead of plan, and the supervisory framework is being enhanced. However, challenges to restoring profitability and a sizeable funding gap may undermine banks' capacity to support the nascent economic recovery through new credit extension. Decisively dealing with increasingly long-term mortgage arrears, reducing overall funding costs, and completing ongoing operational restructurings are important pre-requisites for addressing these challenges. Robust implementation of the new personal insolvency regime and timely reform of the repossession framework, ensuring a delicate balance between debtors' and creditors' rights, are essential to effectively dealing with legacy unsustainable debts. This would also allow banks to normalise their business models and re-focus operations towards profitable new lending, which is essential for a sustained recovery and a reduction of unemployment. Another key policy priority is to enhance SME's access to finance.*

**The important improvement in banks' funding positions is welcome, but concerns remain regarding the funding gap at the end of the programme.** As previously noted, deleveraging and stronger-than-expected deposit inflows have helped to significantly reduce the funding gap<sup>23</sup> of domestically-owned banks<sup>24</sup>. The loss of rating-sensitive non-resident deposits – which saw an outflow of almost EUR 70 billion between end-Q3 2010 and end-Q1 2011 – resulted in increasing reliance on central bank funding, which was already apparent before the start of the programme. Estimates at programme inception had factored in more than EUR 11 billion of wholesale funding which have not materialised to date (despite BOI's and AIB's recent return to the covered bond market), while banks' total assets are also higher-than-anticipated by some EUR 16 billion.<sup>25</sup> Despite these developments, a small outperformance (of about EUR 1 billion) versus original funding gap estimates is expected by end-2012, with the funding gap at end-October having decreased to about EUR 158 billion from a peak of over EUR 237 billion at end-March 2011 (Figure 17). However, given uncertain prospects for sizeable market funding (a challenge currently facing most euro-area banks), and considering that the remaining disposals may be more challenging (as outstanding non-core assets are relatively less liquid and of lower quality), the funding gap could remain considerable, though recent bilateral repo transactions by Irish banks (on Irish assets) with market counterparties and the recent covered bond issues by BOI and AIB are encouraging.

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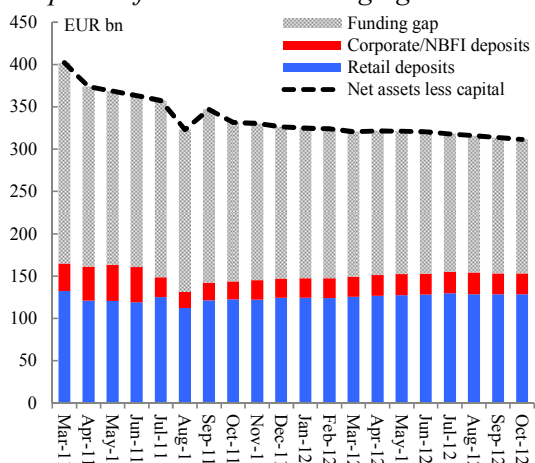
<sup>23</sup> The difference between the volume of a bank's net assets and its aggregate deposit stock.

<sup>24</sup> AIB, BOI, PTSB and IBRC.

<sup>25</sup> This reflects EUR 13.7 billion higher-than-forecast customer loans (resulting from the paused asset disposals at PTSB, FX effects, etc.) and over EUR 8 billion higher other assets (largely Irish government securities).

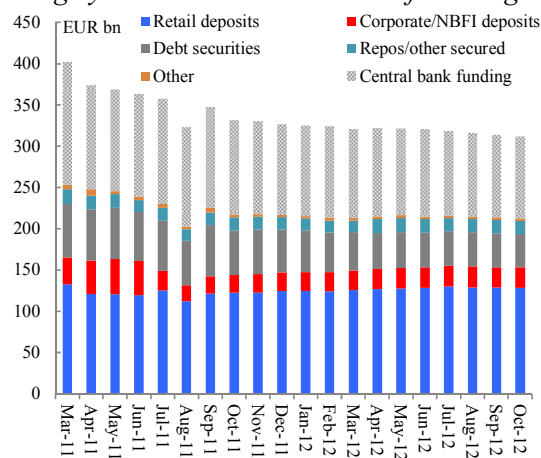
**Figure 17: Covered banks' funding gap**

*The funding gap has gradually decreased as deposit inflows and deleveraging continue*



Source: Central Bank of Ireland

*Funding breakdown shows funding gap is largely covered via central bank financing*

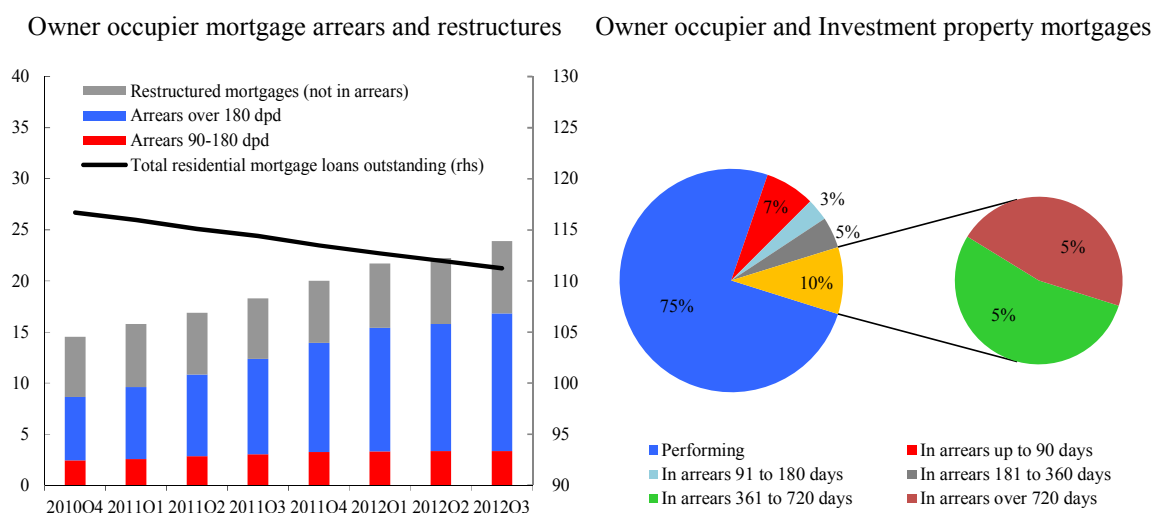


Source: Central Bank of Ireland

**The continued deterioration in banks' asset quality, in particular the long-term nature of mortgage arrears, is a persistent source of concern.** The outstanding balance on owner-occupier mortgage accounts in arrears of over 90 days reached EUR 16.8 billion (Figure 18), equivalent to 15.1% of the total owner-occupier mortgage loan book at end-September 2012. While the pace of mortgage arrears formation has decelerated, the amount of arrears of 180 dpd or more has continued to increase and now stands at over 80% of total arrears. Similarly for investment property mortgages, the outstanding balance of accounts in arrears of over 90 days reached EUR 7.9 billion, equivalent to 26% of the total value of this loan book at end-September 2012; 84% of these arrears are 180 dpd or longer.. While the volume of loan restructurings continues to rise, the focus to date has been on preventing accounts from falling in arrears and on applying often unsustainable short-term forbearance measures. Recently released data shows that almost 10% of the balances of all owner occupier and investment property mortgage loans are in arrears of more than 360 days. Due to considerable difficulties for borrowers to make up for long periods of non-payment and given the lower level of engagement by banks with those borrowers, these levels of arrears could have potentially adverse implications for future recoveries and expected losses on those portfolios. To address this issue the banks have developed a range of long-term loan modification measures which are currently in the process of being rolled out, though the banks' focus on implementing their mortgage arrears resolution strategies needs to be intensified.<sup>26</sup> To avoid further delays with implementation, underpin institutions' efforts and monitor progress, the authorities agreed to introduce quarterly measurable bank-specific targets for reviewing new and existing individual arrears cases from end-2012.

<sup>26</sup> Given the level of loans in arrears and the potential increases in modified loans, it is important that the banks prudently account and provision for all mortgage arrears and restructurings. The authorities have committed to engage with the banks regarding the provisioning treatment for identified loan modification options and will, where necessary, update the 2011 Impairment Provisioning and Disclosure Guidelines to ensure consistency of approach across institutions.

**Figure 18: Mortgage arrears, end-September 2012**



Source: Central Bank of Ireland

**Given continued loan losses and high funding and operating costs, prospects for restoring bank profitability remain fragile.** Actions are underway to improve profitability, with banks continuing to re-price deposits and loan books and to reduce operating expenses in the context of their restructuring plans (Box 4). Reflecting the improved situation and sentiment towards the Irish banking sector, the authorities are prioritising actions for the withdrawal of the ELG scheme in 2013. Banks forecast that annual impairment charges and loan-loss provisions will start to decline from 2012, helping to restore some institutions to modest profitability by end-2014. This is very much dependent on an improving economic environment and decisive implementation of sustainable loan-modification options to treat long-dated arrears. Even if these factors materialise, and loan losses evolve in line with expectations, there are concerns about medium-term profitability given the level and distribution across different arrears' buckets of provisions the banks presently hold relative to the level and age of arrears in their portfolios. While banks have been sufficiently capitalised to an unlikely stress scenario, it is essential that unexpected loan losses are avoided if sustained profitability is to be achieved in the near to medium term, reflecting also banks' weak internal capital generation capacity. Work is ongoing on a detailed assessment of developments at the covered banks relative to PCAR 2011 base and stress scenarios, overall results of which will be published in January 2013.

**The new personal insolvency regime should help facilitate a step-change in the resolution of unsustainable debts.** The Personal Insolvency Bill, which is due to be passed by the Oireachtas by year-end and become operational from early February, seeks to strike a balance between protecting debt service discipline and creditors' rights. It provides a non-judicial alternative to bankruptcy and will assist in securing adequate protections for debtors' principal private residence, also safeguarding reasonable standards of living for the most vulnerable indebted households. From this perspective, Commission services raised concerns about the EUR 3 million cap envisaged in the legislation for eligible *secured* debt. This would appear to be unduly high, given that the average mortgage debt is around EUR 300,000 and could induce banks, lawyers, and insolvency practitioners to focus on big-ticket cases rather than process the smaller but much more numerous cases of average debtors, who are likely to be facing greater

distress. The efficiency of the system could also be jeopardised if the Insolvency service is overloaded with large complex cases, which could involve a multitude of inter-connected debts concerning not only a debtor's principal private residence, but also those associated with investment properties or (sole-trader) businesses. The authorities noted that there are no monetary caps on either unsecured or secured debts in bankruptcy and that during the consultation process stakeholders and the relevant Oireachtas Committee argued that the cap should have been raised or eliminated.

**A functional repossession regime should, however, also be part of the tool-kit to deal with unsustainable legacy debts.** While repossessions should remain a measure of last-resort, maintaining balanced incentives between mortgage borrowers and creditors requires that the existing unintended legislative constraints identified by case law<sup>27</sup>, which could hinder repossession of collateral in some cases of debtor default, is removed.<sup>28</sup> The authorities have committed to removing the unintended legislative constraints, and efforts in this direction will be monitored in future reviews. The issue is particularly pressing for loans related to investment properties, given the level of mortgage arrears in this segment. The mission stressed the desirability of keeping families in their homes wherever possible, and thus the need to ensure that adequate measures are put in place to achieve this.

**Several initiatives have been launched to facilitate credit extension to SMEs.** These include a EUR 90 million Microfinance fund and the Credit guarantee scheme, which is expected to provide an additional EUR 150 million in lending for small businesses per year. In addition, the authorities have agreed with the pillar banks specific targets for a cumulative amount of EUR 21 billion in SME lending (defined as the volume of new sanctions in each year during 2011-2013), which—while not corresponding to similar volumes of *net* new lending—has been an important anchor for bank policy in this area. However, given the continued decrease in the stock of credit to the sector, it is important that any potential impediments to SME access to finance be identified and removed in a timely manner.

**Yet, in view of the importance of SMEs for growth and job creation, more needs to be done.** The mission underscored the importance of the sector for future job creation, but also recognised the difficulty of correctly identifying whether low SME lending mainly reflects weak demand for credit in a low-growth/deleveraging environment or supply-side constraints. As previous reports have indicated, both factors appear to be at work. Furthermore, a particular issue facing many SMEs is adequate access to working capital (as opposed to investment capital) to overcome liquidity constraints which can be exacerbated by payment delays from customers. It is acknowledged that payment delays between businesses, and between businesses and public authorities, can add to business

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<sup>27</sup> Jurisprudence related to the Land and Conveyancing Law Reform Act highlighted unintended constraints which have the effect of limiting banks' ability to realise the value of loan collateral in certain instances. In July 2011 the High Court ruled that a lending institution cannot apply for a repossession order if a mortgage was created before 1 December 2009, but a demand for full payment was not made by the lender until after that date.

<sup>28</sup> The level of repossessions in Ireland, relative to the level of mortgage arrears, is low compared to other jurisdictions. As at end-September 172,000 mortgages were in arrears, 89,000 of which were more than 180 dpd, while cumulative residential mortgage repossessions for the 3 year period to September 2012 were 1652. Furthermore, the costs and average length for a repossession in Ireland remain higher relative to other EU jurisdictions.

costs. Directive 2011/7/EU, which replaces Directive 2000/35/EC, will address this matter and has to be transposed into national law by March 2013. Survey evidence seems to indicate that Irish SMEs may be more credit-constrained than their euro area counterparts.<sup>29</sup> However, unlike the latter, many Irish SMEs significantly increased their exposure to property during the boom years. High leverage and reduced value of their collateral impaired their creditworthiness. The mission discussed with the authorities the importance of exploring options to disentangle SME real estate loans from their core business activities, which may remain viable. In principle, this problem can be reduced as banks move away from collateral-based towards cash-flow-based lending. But a final concern is that banks' capacity to adequately undertake cash-flow analysis may be seriously lacking, particularly at the branch level. This reflects a legacy problem of the property bubble, where banks may have failed to adequately invest in ensuring that their staff possess such basic banking skills. The recent initiative by one of the pillar banks to speed up the loan-application procedure at branch level is, however, welcome. The mission expressed its concern that, unless the wider issue of access to credit for SMEs is addressed, the long-awaited revival in credit growth may encounter bottlenecks which might hinder the future recovery. The mission also called for carrying out a comprehensive study on regulatory, administrative and financial burdens for SMEs, but the authorities suggested that this may be more appropriately considered following completion of ongoing surveys. Welcome steps to support lending to the sector were made in Budget 2013 following publication of the 10 Point (SME) Tax Plan and the announcement that the NPFR will establish and invest in funds to provide equity, finance, restructuring and recovery investment funding for SMEs of up to EUR 400 million (0.2% of GDP).

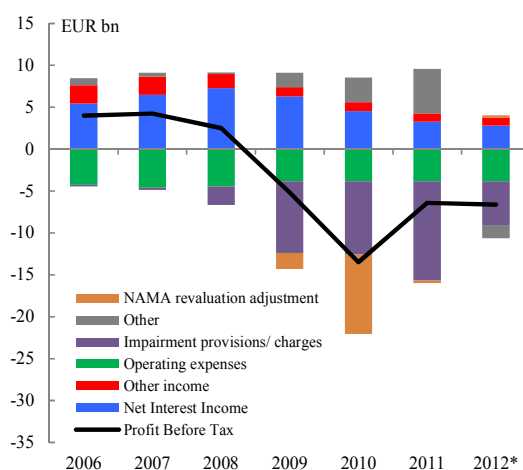
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<sup>29</sup> According to the latest [ECB SAFE Survey](#), at 23% rejection rates in Ireland remained well above the euro area average (15%). A [RedC survey](#) commissioned by the Department of Finance however found that for the April-September 2012 period, the decline rate from banks had reduced to 19% from 23% relative to previous waves, amid a slight increase in demand for credit from SMEs.

#### Box 4: Restoring bank profitability<sup>30</sup>

**Bank profitability remains challenged by high funding costs, operating expenses and loan impairment losses** (Figure 19). Despite the sizeable availability of low-cost Eurosystem funding, about half of covered bank assets are deposit-funded; hence their overall financing cost had been deteriorating due to deposit price distortions and increased ELG fees<sup>31</sup>. Net interest income at the covered banks decreased by over 40% since 2010 due to higher funding costs (also compressing margins on new business), the low interest rate environment and limitations on banks' capacity to re-price large portions of their back-books. Even though operating expenses have remained broadly stable, their share of banks' gross operating income increased to over 100% on average from about 70% in 2010. As loan arrears continue to increase (albeit at a slower pace), additional impairment provisions are expected, which will continue to weigh on bank profitability.

**Figure 19: Drivers of covered bank profitability**



Source: Covered banks' Annual reports and Interim Financial Statements  
Notes: (i) 2012 data is annualised; (ii) "Other" includes income from LMEs

**Reducing funding costs through both a withdrawal from ELG and further deposit rate decreases is essential to restoring profitability.** ELG fees considerably reduce banks' pre-provision profits and a strategy for the phase-out of the scheme (already completed for the UK operations of covered banks) in early 2013 remains a key priority for the authorities. This could constitute aggregate 12-month savings of about EUR 0.9 billion<sup>32</sup>, though the full impact on bank profitability is likely to materialise only in 2014, given the current maturity profile of covered liabilities. The intense competition for deposits observed in the second half of 2011 and in early 2012 has started to abate with retail deposit rates starting to normalise particularly in the short-term product categories (e.g. redeemable at notice deposit rates down by 0.48% since January). However, further deposit rate reductions may be necessary to contribute sufficiently to reducing banks' overall cost of funding and normalise net interest margins. As adjustments of funding cost will take time as banks gradually replace low-cost Eurosystem financing with market-based funding, adequate volumes of new lending at appropriate spreads are also a

<sup>30</sup> Data corresponds to banks' Annual Reports, with 2012 figures annualised and sourced from banks' end-June 2012 Interim Financial Statements.

<sup>31</sup> The average effective ELG cost for participating banks more than doubled since the scheme's inception, from 50 bps on average covered liabilities in Q1 2010 to about 110 bps in 1H 2012. For full details of ELG fee structures as of 1 January 2012 see [Annex 7](#) of the Rules of the Credit Institutions (Eligible Liabilities Guarantee) Scheme 2009.

<sup>32</sup> Fiscal projections reflect EUR 0.4 billion of ELG fees through end-January 2013 and assume the scheme is not extended further.

necessary pre-requisite to fully restoring profitability.

**Operational rationalisation is also essential for reducing costs.** The banks are advancing voluntary severance, redundancy and early retirement schemes, and pursuing other cost-saving initiatives, including outsourcing of non-core functions, the closure of branches (circa 80 branches have been identified for closure in 2012 and 2013) and adjustments to staff benefits and pensions. All these measures combined are expected to generate annualised reductions of operating expenses of over EUR 450 million by end-2013. Despite these important initiatives, cost bases at the covered banks would likely continue to remain large in relation to gross operating income, given the drag of low-yielding long-dated legacy assets, and limited new lending and prospects for increasing non-interest income. That said, the three covered banks plan to enhance their efficiency considerably in coming years through operational and funding cost reductions and profitable new lending, targeting cost/income ratios of 50-55% by 2015 (significantly below current levels of 90% - 115%).

**Serious risk to a sustained return to bank profitability in the medium term is posed by further increases in loan impairment charges.** Encouragingly, the pace of mortgage arrears' formation has started to decelerate, as banks have enhanced the effectiveness of their collections and work-out functions and sought early engagement with customers in difficulty. This addresses a key near-term risk to bank profitability. However, concerns remain regarding low levels of cure in long-dated arrears, reflecting considerable challenges and unwarranted delays for banks' implementation of advanced loan modification options on sufficient scale. As a result, impairment losses can be expected to continue to increase in the near term as sizeable proportions of long-term non-performing loans may be unable to cure and may need to be written off. Provisions are also likely to increase further weighing on profitability in coming quarters, in light of further deteriorations of banks' mortgage portfolio, as well as SME and CRE portfolios (average coverage ratios have actually declined to 55% at end-June from 58% at end-September 2011) and taking account of revisions, where necessary, to existing guidelines with regard to the provisioning treatment of certain advanced forbearance options. In addition, some structural features of Ireland's regulatory framework, such as the existing legal impediments to collateral repossession in some circumstances, reduce the recovery value of collateral and thus, unless addressed, may require an increase in provision cover.

### 5.3 Structural reforms

*Structural reforms to strengthen the economy in the medium term continue to progress broadly in line with programme objectives. Persistently high unemployment, increasingly of a long-term nature, is a major social and economic concern that needs to be addressed forcefully. The functioning of the labour market is being improved, including through more effective activation policies and greater flexibility in sectoral wage setting arrangements, with a view to ensuring a job-rich recovery in the future, but faster and deeper progress is needed. The process to transfer the ownership and operations of the water sector to a national public utility and introduce water charges for households is advancing, but at a slow pace. In turn, the competition framework continues to be strengthened, and the process to dispose of selected State assets is moving according to plans.*

**Labour market reforms are advancing and should improve Ireland's ability to generate a job-rich recovery in the future.** The Industrial Relations (Amendment) Act 2012, adopted in July, imposes a stricter legal framework for the setting of the terms and conditions defined by Registered Employment Agreements (REAs) and Employment Regulation Orders (EROs), including sectoral minimum wages. The Act mandates the Labour Court or the Joint Labour Committees (JLCs) to examine a number of factors prior to registering an REA or submitting an ERO, including the impact on employment, the consequences in terms of competitiveness, and the relative wage levels in other EU Member States where relevant. In addition, REAs and EROs have become subject to

Ministerial approval. Overall, these reforms should enhance labour market flexibility in the future and ensure that proper consideration is given to job creation and competitiveness issues in negotiating sectoral minimum wages and working conditions.<sup>33</sup> This, together with the measures envisaged and implemented under the Action Plan for Jobs, should help promote employment creation in the future and ensure that wages are adequately linked to productivity levels. The Act also makes it easier for a party to an REA to call for a renegotiation of its terms. The renegotiation process mandated by law remains relatively slow and burdensome however, and the impact of the amendment will have to be monitored in the year ahead.

**The authorities launched *Intreo* in October as an integrated platform for labour activation services.** Under the *Pathways to Work* initiative, the authorities aim to improve activation by increasing engagement with the unemployed, providing more training opportunities, ensuring proper incentives to taking up job opportunities, promoting the recruitment of the unemployed and reforming the institutional set up. *Intreo* has been designed as a one-stop-shop for job seekers and employers alike. Once fully phased-in, jobseekers will go to *Intreo* offices both to determine their entitlements and to receive employment services. Employers, in turn, should receive support in identifying suitable candidates to fill vacancies and obtaining eligible incentives. Four *Intreo* offices were launched in October. A few more should be opened by end-2012 and work is under way to expand the network throughout 2013 to reach the nationwide target of 70 offices by 2014.

**Active engagement of the unemployed has improved, but remains insufficient.** As of end-October, about 55,000 jobseekers had gone through group engagements (significantly ahead of target), while almost 42,000 had been individually profiled. Under group engagements, jobseekers with similar profiles are provided with general information on the options and support measures available to them. Individual profiling, in contrast, offers more tailored support and is an essential component of the labour activation policy. At this stage, individual profiling and group engagement are prioritised on new entrants on the Live Register because of resource constraints. It is crucial, however, that the long-term unemployed become engaged in labour activation measures rapidly as they are at an increasing risk of complete marginalisation from the labour market and as their numbers are bound to increase in the near future.

In order to address resource constraints, the authorities are taking steps to outsource some engagement activities to the private sector under a payment-by-results contractor model. While some progress has been made already, the authorities expect to finalise the contract design and initiate the tendering procedure only by the first quarter of 2013, with actual referrals to the contractor(s) commencing no sooner than the end of October 2013. As much as possible, this process needs to be speeded up to ensure timely engagement with a

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<sup>33</sup> The stricter legal framework imposed upon the Labour Court and JLCs in determining the terms of conditions or REAs and EROs addresses the issue arising from the High Court ruling of July 2011 that declared some of the provisions of the Industrial Relations Act 1946 and Industrial Relations Act 1990 unconstitutional, effectively rendering EROs invalid. The Industrial Relations (Amendment) Act 2012 mandates all EROs to be reviewed "as soon as practical" upon adoption, at least once every five years thereafter. The review of EROs has only just started, however, and should take place over the next few quarters. In turn, renegotiations of REAs will take place upon the initiative of individual parties. The authorities will report on the impact of the review and renegotiation process in the second quarter of 2013.



larger proportion of the long-term unemployed and reduce risks that emerging mismatches remain entrenched and human capital is forsaken. Partial outsourcing has been used successfully in a number of EU countries already and should usefully complement *Intreo's* services and enable the provision of employment services at the lowest possible cost. In order to ensure optimal outcomes, the procurement process will need to be as competitive as possible. The performance of providers should be monitored in the future, with the low-performing ones eliminated from the market.

**The impact of labour market reforms on unemployment has remained muted so far but should pay off once the recovery gathers pace.** Economic growth over the past two years has not been sufficient to generate net job creation, and activation policies alone will not be sufficient to bring about a sharp drop in unemployment. The authorities are aware of this and adopted the *Action Plan for Jobs* in an effort to promote growth through an improved business climate and sectoral initiatives. Significant progress has been achieved in implementing the *Action Plan for Jobs*, but higher growth will be needed to achieve significant cuts in unemployment. Addressing high and long-term unemployment will require a combination of growth-induced job creation, improved labour-market functioning, and a better match between the demand and supply for skills (Box 5).

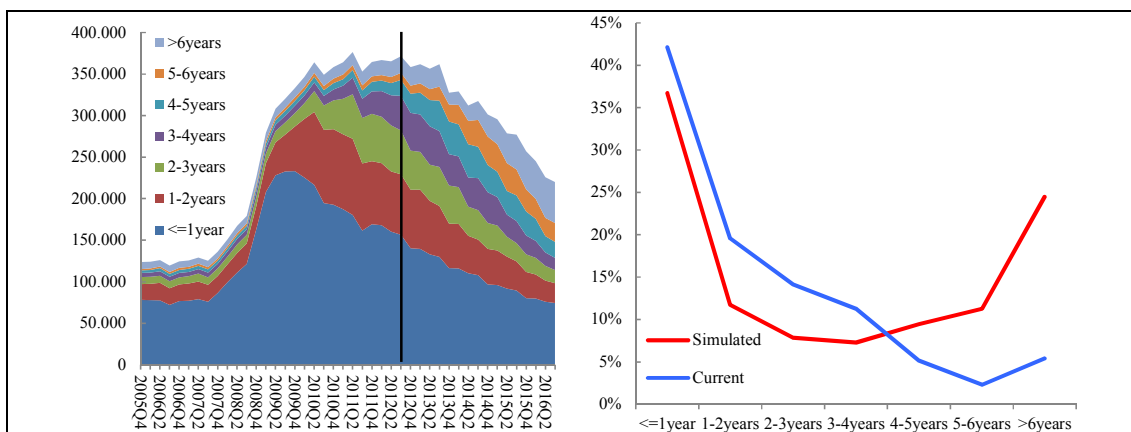
**The Competition Authority is finally receiving its scheduled staff boost,** meant to ensure that the Competition (Amendment) Act 2012 translates into an improved monitoring and enforcement of competition rules. Three of the 10 supplementary professional staff members had been recruited by end-October, and applications were being received for the remaining 7 posts. The additional staff will represent a mix of economists and lawyers, who are all scheduled to work as case handlers.

**Box 5: Breaking the cycle of long-term unemployment: activation, re-skilling and job creation**

Unemployment has ceased to increase in 2012, but this provides little comfort as the rate is stuck at a high of about 14.8% and as joblessness is increasingly long-term in nature. By September 2012, close to 60% of the people on the Live Register had been unemployed for more than a year. In addition, the majority of the long-term unemployed are at the low-end of the skill range, and their employability is further affected by the length of time they remain away from activity.

Addressing the (long-term) unemployment issue is an increasingly pressing policy concern that requires a comprehensive reform strategy. Under a baseline scenario of a gradual return to pre-crisis exit rates, it appears that the number of people on the Live Register would decrease only very gradually to around 220,000 by end-2016, and that the long-term nature of unemployment would actually worsen further, with close to 65% of people on the Live Register for more than one year. While such a simulation needs to be taken with extreme caution when it comes to precise numbers, the main findings are robust regardless of the scenarios envisaged and highlight two key policy issues: (1) a job-rich recovery will be essential to make a sharp indent in unemployment levels; and (2) major efforts will be required to further improve labour activation policies and generate much higher exit rates for the long-term unemployed, including through re-skilling and training.

**Figure 20: Actual and simulated population on live register by duration**



Sources: Department of Social Protection and European Commission calculations.

As indicated earlier, 50% of the population currently on the Live Register previously held occupations in craft, sales or plant and machine operations, i.e. towards the low-end of the skills distribution. The National Skills Bulletin 2012 by the Expert Group on Future Skills Needs, in turn, indicates that Ireland currently suffers from skills gaps in a number of areas, including science, engineering, IT and certain segments of sales and marketing, craft and transport.

While it would be illusory to aim at fundamentally reshaping the skills of people currently on the Live Register on a large scale, a core element of the labour activation policy must be to offer additional or new training to the unemployed, particularly the long-term ones, on a timely and targeted basis. As such, a faster implementation of the establishment of SOLAS to better coordinate and direct the local Education and Training Boards (ETBs) is essential. Regularly reviewing ETBs' curricula and trainings offers to ensure they are relevant to employer's needs and demands will also be important in the future.

The relevance and effectiveness of *Intreo's* services to job seekers and employers will need to be reviewed as offices are phased in nationwide in 2013. Reaching targets on the number of people to be profiled or sent to group engagement will not be sufficient. The quality and relevance of the individual profiling and group sessions will be at least as important, and *Intreo* will have to ensure that it adequately services the needs of job seekers in terms of guidance and training and the needs of employers in identifying and short-listing potential candidates to fill vacancies.

Aside from forceful implementation of the labour activation policy defined in *Pathways to Work*, further action will be needed to improve the demand side of the labour market. The solid implementation record on the *Action Plan for Jobs* in 2012 should be continued looking forward. Efforts should also be made to ensure that the increased labour market flexibility intended to be achieved through the Industrial Relations (Amendment) Act 2012 actually materialises.

**The Legal Service Regulation Bill, a programme requirement, has completed second stage and committee stage is planned for early 2013.** Amendments are to be introduced to reflect concerns over the independence from government of the new Regulatory Body.<sup>34</sup> With the bill's passage, the authorities should work to ensure speedy and effective implementation of the reforms, which are important to competitiveness (Box 6).

**Plans to transfer the ownership and operation of the water sector to a national public utility and introduce charges for households have firmed up.**<sup>35</sup> Aside from settling on the public utility model, a number of important decisions have been taken,

<sup>34</sup> As these amendments have not yet been made available, it cannot be assessed whether these concerns will be fully addressed.

<sup>35</sup> As reported in previous reviews, the Government settled on a national public utility model to operate the water sector following an independent assessment published in November 2011. An implementation strategy to transfer operations from local authorities to Irish Water was finalised in July 2012.

including that: (1) Irish Water will be an independent State-owned company under the Bord Gáis Group; (2) the water sector will be subject to the independent regulatory oversight of the Commission for Energy Regulation (CER); (3) water charges will be generalised to all consumers (residential as well as non-residential) by 1 January 2014; (4) a sustainable funding model for the sector will be established, with the aim to make Irish Water self-funded eventually; and (5) the transfer of ownership and operations of the sector from local authorities to Irish Water will be phased in gradually over a period of around 5 years extending to 2017.

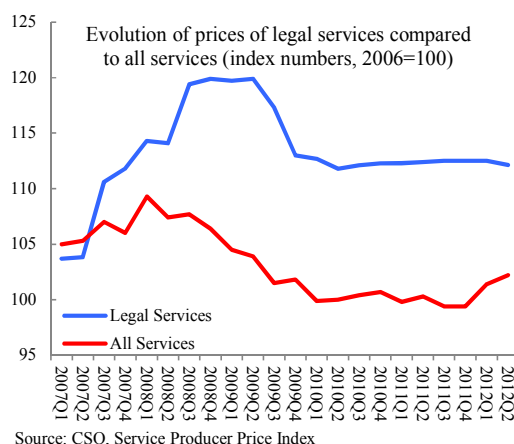
**The implementation of the water reform strategy has so far been slow.** The reform has nevertheless been planned since the beginning of the programme and is critical on a number of counts, including: (1) to foster an efficient and rational use of a scarce and valuable resource; (2) to ensure the viability of the sector's business model; and (3) to enable the financing of essential infrastructure investments, including to reduce leakages and ensure adequate service provision to suit the needs of businesses. Making Irish Water mostly self-funded like any other public utility will also generate significant structural savings for the Exchequer as operating and capital costs represent around EUR 1.2 billion per annum, with revenues from charges to non-residential users accounting for only EUR 200 million. Yet, concrete steps have been taken slowly. Among other things, progress towards the installation of water meters has lagged. The procurement processes for the supply of boundary boxes and the installation contracts are yet to be completed, and the authorities recognise that actual installation of boundary boxes and meters will not start until the third quarter of 2013. The full roll-out of meters is likely to take years and extend well beyond the scheduled date for the introduction of water charges, which will create additional difficulties regarding the pricing mechanism.

**Landmark decisions are needed in the coming months to achieve the commitment of introducing water charges for households by the end of the programme period.** Given the delays experienced so far, a number of key steps and decisions will have to be taken rapidly, including: (1) the enactment of legislation to grant regulatory oversight to the CER; (2) the enactment of a comprehensive Water Services Bill; (3) the establishment of Irish Water first on an interim basis and later in its final form; (4) the installation of meters; (5) the determination of a pricing methodology for households and non-residential users (both before and after meters are in place, i.e. respectively on a presumptive and on an effective-consumption basis); and (6) a decision on the level of Exchequer funding in the years to come and until Irish Water is put on self-funded basis. The latter two issues are closely interconnected, as the level of Exchequer support required for Irish Water will depend on the revenues that can be collected through the introduction of water charges for households. These steps are reflected in the revised memorandum of understanding, and the authorities are committed to engage with the European Commission in developing the new legislative arrangements for the sector.

### Box 6: Increasing competition in the provision of legal services

Whereas other sectors of the economy have experienced considerable cost adjustments since the onset of the crisis, legal services remain expensive in Ireland (Figure 21). After rapid increases during the boom, the cost of legal services only adjusted slightly, and still remained 12.1% above their 2006 level. This contrasts markedly with the post-crisis development of other services, whose prices did not rise as much to begin with and have since adjusted quickly back to 2006 levels (Figure 21). The World Bank Doing Business 2012 report estimates that, as a percentage of the value of a standardised claim in a commercial dispute, the enforcement cost is 26.9% in Ireland, versus an OECD average of 20.1%. Of this, more than 2/3 (i.e. 18.8%) is accounted by attorney costs.

**Figure 21: evolution of legal services prices vs. other services**



Source: CSO, Service Producer Price Index

The high cost of legal services continues to pose problems for Ireland:

- Cost competitiveness, in particular for SMEs, for which the high level of legal costs can act as an impediment to business success, particularly in contentious contract law issues. Since non-tradables like legal services also feed into the cost base in the Irish export sector, high legal service costs also hamper external competitiveness;
- Equity concerns, as low income households who cannot afford high legal fees may be locked out of equal access to justice;
- Fiscal issues, as the State is the largest buyer of legal services, making high legal costs a further challenge in terms of meeting fiscal targets under the Programme.

A 2006 study by Ireland's Competition Authority<sup>36</sup> identified anti-competitive practices in the market for legal services, such as the potential conflict of interest between the regulatory and representative role of the Law Society, the Bar Council and (for qualification and disbarment of barristers) the King's Inns. Unnecessary barriers to competition include bans on advertising, bans on the formation of partnerships and restrictions in the free availability of training and accreditation into the profession. The lack of a separate profession of conveyancer also works to constrain labour supply.

The Legal Services Regulation Bill, a programme requirement, addresses many of these issues, in particular through the establishment of a new Legal Services Regulatory Authority, which will have overarching regulatory control over the Law Society and Bar Council. Further, its establishment is a vital first step in the implementation of further potential reforms. Renewed consideration should also be given to some recommendations of the 2006 study, notably the prohibition of the 'solicitor's lien' (by which solicitors may hold a client's file pending payment of fee). It is important as well to note that the full cost savings in legal services requires further modernisation and higher efficiency of judicial procedures and the entire judicial system. Finally, the authorities should ensure timely and effective implementation of the measures to achieve the benefits quickly.

<sup>36</sup> [Competition in Professional Services: Solicitors and Barristers](#), Ireland's Competition Authority (2006)

**Non-strategic state assets in the energy sector identified for disposal by the government are nearing the point of sale, with some uncertainty around the use of proceeds.** The financial and legal advisors for the sale of Bord Gáis Energy (BGE) have been appointed recently, and other necessary steps are being taken to initiate the sale in early 2013. Progress towards the sale of selected non-strategic power generation assets of the Electricity Supply Board has been slower, and no final decision has been taken on which units will be privatised. The authorities nevertheless aim to initiate the transaction procedures in the first half of 2013. They are also committed under the programme to use at least half of the privatisation proceeds for debt reduction, with the balance invested in growth-enhancing projects of a commercial nature. Precise projects which would benefit from funds from privatisations receipts have yet to be identified.

## **6. Financing issues**

**The completion of this review would trigger a disbursement of EUR 0.8 billion from the EFSM/EFSF.** The IMF will disburse an additional EUR 0.9 billion and the UK a bilateral loan of EUR 0.5 billion. This will bring disbursements at end-2012 to EUR 56.6 billion, representing 84% of the total international assistance of EUR 67.5 billion available under the programme.<sup>37</sup>

**The improved market sentiment discussed earlier in the report has allowed the authorities to plan for further debt issuances in 2013.** Ireland plans to issue short-term T-bills regularly in the future, establishing again a stable market presence. The authorities also want to step-up the issuance of long-term bonds. Long-term debt can be expected to be issued in bond auctions or syndications, while additional funding options such as more amortising bonds designed for the domestic pension fund industry are also considered.

**The latest funding plans have resulted in upwards revisions of the projected cash balances compared to previous missions.** By the end of 2013, the treasury's cash buffer should stand at EUR 17.4 billion (Table 3), which is about the equivalent to the financing needs for the following year.<sup>38</sup> The substantial pre-funding of the cash buffer also serves as a positive signal to bond investors and should, together with continued strong programme implementation, make for favourable trends in yields and investor appetite for sovereign bonds. The authorities have also signalled their interest in discussing during coming reviews how best to support continued market access once the economic adjustment program expires at end-2013.

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<sup>37</sup> The EFSM/EFSF is expected to disburse the EUR 0.8 billion associated with this review in early 2013.

<sup>38</sup> Including the EUR 7.6 billion bond redemption in January 2014.

**Table 3: Financing requirements**

	2010	2011	2012					2013					2010-2013
	Dec	Year	Q1	Q2	Q3	Q4	Year	Q1	Q2	Q3	Q4	Year	Total
<b>A. Exchequer cash deficit 1/</b>	5.4	18.4	4.3	6.9	1.7	4.2	17.1	4.7	6.6	1.4	2.6	15.4	56.3
<b>B. Debt redemption 2/</b>	2.5	9.7	6.3	-0.6	-0.7	4.7	9.7	1.5	7.1	1.5	1.0	11.2	33.0
of which: long term bonds	0.0	4.8	5.6	0.0	-0.3	0.0	5.4	0.0	5.6	0.0	0.0	5.6	15.8
<b>C. Bank recapitalisation</b>	0.0	16.6	0.0	1.3	0.0	0.3	1.6	0.0	0.0	0.0	0.0	0.0	18.1
<b>D. Other Financing needs 3/</b>	0.0	0.7	0.2	-0.9	0.0	1.3	0.6	1.0	0.0	0.0	0.5	1.5	2.8
<b>E. EU-IMF loan disbursement</b>	0.0	34.5	10.5	4.4	3.7	2.7	21.3	4.1	2.9	2.4	2.3	11.7	67.5
EFSM/EFSF	0.0	21.5	6.2	2.8	2.3	1.0	12.3	2.4	1.4	1.4	1.2	6.4	40.2
Bilaterals 5/	0.0	0.5	1.1	0.2	0.5	0.8	2.5	0.7	0.5	0.3	0.4	1.8	4.8
IMF	0.0	12.6	3.2	1.5	0.9	0.9	6.4	1.0	1.0	0.8	0.7	3.5	22.5
<b>F. Market Funding</b>	0.5	1.4	0.4	3.4	6.5	2.0	12.4	5.1	4.2	3.7	3.2	16.1	30.4
of which: long term bonds	0.0	0.0	0.0	3.1	5.1	0.0	8.1	3.0	2.5	2.0	2.0	9.5	17.6
<b>Memorandum item:</b>													
Cash balances, eop	22.3	12.9	13.1	14.2	23.4	17.6	17.6	19.6	12.9	16.1	17.4	17.4	

Notes:

1/ Includes promissory note payments

2/ Includes long-term bonds, T-bills, commercial paper and others

3/ Include contingencies

4/ Includes Treasury cash reserves and NPRF assets

5/ UK, Sweden and Denmark.

## 7. Risks

**Despite the considerable progress made and the early signs of returning investor confidence, the Irish economy faces several key challenges and risks, as fully addressing legacy imbalances from the bubble period (e.g. public, private and external debt) and returning to sustained and job-rich growth will take time and continued policy determination.**

**The main risks stem from:**

- **A further deterioration in the growth outlook.** Further delays in sustained and substantial recovery and potential downward revisions in the medium/term growth outlook would increase fiscal, banking and political risks.
- **Dwindling political support for fiscal consolidation.** Further decisive action is required to reduce Ireland's budget deficit, which remains the largest in the euro area, and put the debt ratio on a firmly downward path. While the government's commitment to meeting fiscal targets is not in doubt, doing so in an equitable manner will require it to make some hard choices and confront some vested interests. Thus, a key risk stems from the difficulty of maintaining broad-based political support for fiscal consolidation.
- **Banks' large arrears and weak profitability.** Irish banks have been capitalised to a very high level relative to peers in other European countries and relative also to a conservative adverse scenario based on highly credible stress tests. Yet the risk of possible further capital needs in the future cannot be fully excluded, especially if the growth outlook deteriorates beyond what is currently expected. To minimise this risk, banks need to take decisive action to address arrears and further reduce operating costs.
- **Impaired credit intermediation.** Bank lending to the private sector, and in particular to SMEs, may fail to revitalize unless banks cleanse their loan portfolios from

unsustainable debts and develop their capacity—especially at the branch level—to lend based on cash-flow analysis rather than merely on the value of property collateral, as was too often the case in the boom years.

- **Increase in structural unemployment.** Despite a positive start under the Pathways to Work initiative, labour market activation policies need to be significantly strengthened to avoid a situation where the unemployed remain too much time out of work and end up not having the appropriate skills to match future jobs when employment growth starts to pick up.
- **Market sentiment still fragile.** The recent decline in spreads reflects strong programme implementation and expectations of programme enhancements following the supportive statements from the euro area leaders in June and July. There is, therefore, a risk that hard-earned gains might unravel if progress on this front takes longer than can reasonably be expected.

## List of abbreviations

AIB	Allied Irish Bank
BOI	Bank of Ireland
BGE	Bord Gáis Energy
BTL	Buy-to-Let
CBI	Central Bank of Ireland
CER	Commission for Energy Regulation
CPI	Consumer Price Index
CSO	Central Statistics Office
dpd	Days Past Due
EC	European Commission
ECB	European Central Bank
EDP	Excessive Deficit Procedure
EFSF	European Financial Stability Fund
EFSM	European Financial Stabilisation Mechanism
ELG	Eligible Liabilities Guarantee
EMU	Economic and Monetary Union
ERO	Employment Regulation Order
ETB	Education and Training Board
GDP	Gross Domestic Product
GNP	Gross National Product
GP	General Practitioner
GVA	Gross Value-Added
HICP	Harmonised Indices of Consumer Prices
HSE	Health Service Executive
IBEC	Irish Business and Employers Confederation
IBRC	Irish Bank Resolution Corporation
IMF	International Monetary Fund
JLC	Joint Labour Court
ma	Moving average
MEFP	Memorandum of Economic and Financial Policies
MOU	Memorandum of Understanding
MTFS	Medium Term Financial Statement
NAMA	National Asset Management Agency
NFC	Non-Financial Corporation
OECD	Organisation for Economic Co-operation and Development
PCRS	Primary Care Reimbursement Service
PCAR	Prudential Capital Assessment Review
PLAR	Prudential Liquidity Assessment Review
PMI	Purchasing Managers Index
PTSB	Permanent TSB
REA	Registered Employment Agreement
REER	Real Effective Exchange Rate
ROI	Republic of Ireland
sa	Seasonally Adjusted
SME	Small and Medium Enterprise
WHO	World Health Organisation



## Annex 1: Debt sustainability analysis

The assessment of the sustainability of Ireland's public debt by the Commission services has not materially changed from the previous review. The main differences relate to the somewhat higher cash buffers in the near-term, following the successful issuances discussed in the paper, which also translates in somewhat higher *gross debt* figures.

The programme's baseline scenario assumes a continued gradual increase in the primary surplus in the post-programme period, from 0.7% of GDP in 2014 to 2.1% of GDP in 2015 and to 4.8% in 2020, based on: (i) programme's projections and EDP requirements until 2015 and (ii) an annual adjustment in government deficit of 0.5pp of GDP in 2016-2020 (Figure 22). This path is consistent with gross debt peaking at 122.1% of GDP in 2013, and declining steadily thereafter to 103% of GDP by 2020. The debt at the peak includes sizable cash balances of EUR 17.4 billion (10% of GDP) at end-2013, which are assumed to be reduced to EUR 10 billion at end-2014 and EUR 9 billion at end-2015. The programme debt projections foresee the full drawdown of the programme financing envelope. The baseline scenario assumes nominal GDP growth of 4.4% and a marginal interest rate of 5.5% over the period 2016-2020. The growth rate is higher than the 4% potential nominal growth as calculated by the harmonised methodology for 2016, reflecting an assumed faster growth in investment, allowing the latter to return to more normal levels (investment under the baseline is still forecast at only 12% of GDP in 2015).

A stress scenario with a 1 pp. lower GDP growth shows that, in the absence of additional consolidation measures, debt would veer away from the sustainable path. In particular, sticking to the currently agreed annual adjustment in 2013-15 in the face of lower growth, and thus missing the programme nominal deficit targets, would result in a deficit of 5.2% of GDP in 2015, well above the programme target of below 3% of GDP. Even assuming that the deficit ratio would be reduced by 0.5 pp. each year over 2016-20, the deficit ratio would only fall below 3% in 2020, and result in a debt level of 123% of GDP in 2020, with a peak not achieved until 2016-17. If instead additional measures are taken to ensure that the programme and EDP deficit path is respected, the debt ratio would begin declining in 2015, though of course the lower growth (including as a result of the contractionary impact of additional measures) would keep the 2020 debt ratio at a higher value (around 110% of GDP) than under the baseline (Figure 23). A scenario with a substantially higher marginal interest rate (7.5%) does not materially alter the debt trajectory due to relatively low refinancing needs.

Figure 22: Debt-stabilising primary balance in baseline projections (% of GDP)

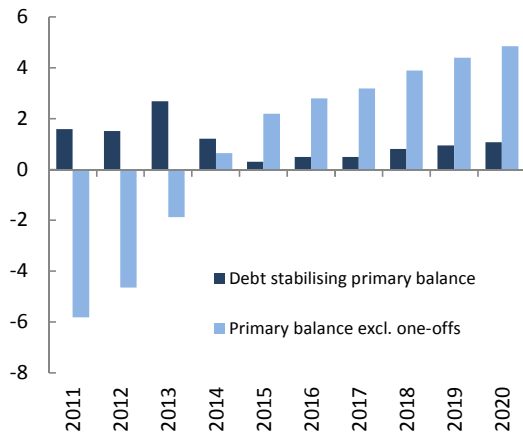
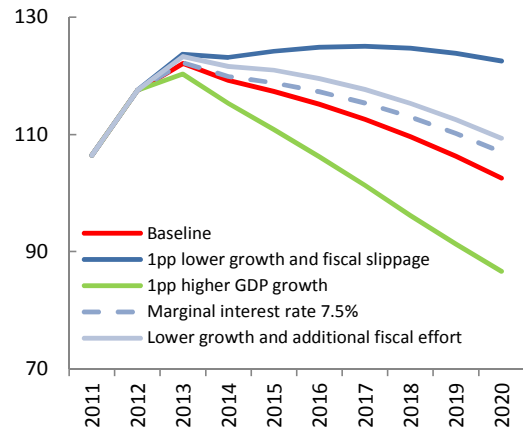


Figure 23: Government debt projections (% of GDP)



Source: Commission service's estimates

Notes:

*Baseline assumptions:* Programme projections until 2015 (including cash balances of EUR 18.1 billion at the end of 2012, EUR 17.4 billion at the end of 2013, EUR 10 billion at the end of 2014 and EUR 9 billion at the end of 2015). After 2015, general government deficit is reduced by 0.5pp annually until balance is reached; real GDP growth of 2.8% (4.4% nominal growth); marginal interest rate on new government bonds of 5.5%; cash balances of EUR 9 billion maintained in each year. Some 10% of the general government debt, including short-term debt, local government debt and other general government liabilities assumed to remain unchanged/rolled over at constant rates without contributing to analysis dynamics.

*Stress scenario assumptions:* GDP scenarios assume lower/higher nominal GDP, and a 0.5 sensitivity of fiscal balance to GDP. In the scenario with no policy response (represented by the dark blue in the figure above) the planned annual fiscal consolidation effort until 2015 is maintained, while annual fiscal deficit targets may not be met. The budget deficit in this scenario would be 5.2% of GDP in 2015 and 2.7% of GDP in 2020. In the scenario with additional fiscal effort (grey line in figure above), the government ensures that the fiscal deficit targets under the programme/EDP are met, even though this requires additional consolidation measures and has an additional contractionary impact on growth. For both these two latter scenarios, from 2015 onwards the general government deficit is reduced by 0.5 pps annually until balance is reached (for comparison, in this scenario the budget deficit in this scenario would be 3% of GDP in 2015 and -0.5% of GDP in 2020).

## Annex 2: Supplementary tables

**Table A1: Health expenditure overruns in 2012**

		7th review		8th review	
		cash	EUR million accrual	cash	accrual
A	<b>Savings envisaged in 2012 Budget</b>	<b>543</b>	<b>543</b>	<b>543</b>	<b>543</b>
	Hospital income from private health insurance	143	143	143	143
	Demand Led Schemes	124	124	124	124
	Employment numbers and pay	145	145	145	145
	Long stay repayment scheme	11	11	11	11
	Efficiencies in disability, mental health & childcare	50	50	50	50
	Other measures (procurement)	70	70	70	70
B	<b>Emergent spending pressures since 2012 Budget time</b>	<b>317</b>	<b>317</b>	<b>357</b>	<b>357</b>
	Hospital activity	150	150	150	150
	Pension lump sum costs	46	46	46	46
	New high tech drugs	15	15	15	15
	VAT	50	50	50	50
	EU agency directive	15	15	15	15
	Other (residual)	41	41	41	41
	Additional pressures on PCRS 1/			40	40
C= A+B	<b>Total spending pressures relative to no-policy change baseline underlying 2012 budget</b>	<b>860</b>	<b>860</b>	<b>900</b>	<b>900</b>
D	<b>Savings expected from measures effectively implemented</b>	<b>503</b>	<b>378</b>	<b>348</b>	<b>233</b>
	Hospital income from private health insurance	125	0	115	0
	Demand Led Schemes	119	119	69	69
	Employment numbers and pay	135	135	75	75
	Long stay repayment scheme	11	11	11	11
	Efficiencies in disability, mental health & childcare	25	25	-10	-10
	Other measures (procurement)	88	88	88	88
E	<b>Envisaged additional measures</b>	<b>357</b>	<b>205</b>	<b>343</b>	<b>146</b>
	Intensification of agency, overtime	129	129	100	100
	Exchequer funding of HSE pensions	46	46	46	46
	Additional savings on generic drugs costs	20	20	0	0
	Medical Defence Union receipts	45	0	45	
	Transitional Care Programme	16	0	16	
	Time related savings in mental health/primary care	53	0	53	
	Savings on National Treatment Purchase Fund expenditure	10	0	30	
	Capital expenditure savings	28	0	28	
	Other savings	10	10	10	
	Additional savings in Vote 38 1/			15	
F= D-E	<b>Remaining estimated overrun</b>	<b>0</b>	<b>277</b>	<b>209</b>	<b>521</b>

Note: 1/ New information as of October 2012 review mission.

Source: DPER, Ministry of Health

**Table A2: Fiscal performance in 2012**

EUR million	Jan-Nov 2012			2012		
	Outturn	SPU target	Outturn vs target	SPU target	Budget for 2013	Estimate vs target
<b>Revenue</b>	<b>43 483</b>			<b>47 292</b>	<b>46 881</b>	<b>-411</b>
<b>Tax revenue</b>	<b>39 901</b>	<b>40 449</b>	<b>-547</b>	<b>43 462</b>	<b>42797</b>	<b>-665</b>
<i>Personal income tax</i>	13 872	14 103	-231	15 300	15040	-260
<i>VAT</i>	9 966	9 786	180	9 995	10190	195
<i>Corporation tax</i>	3 810	3 831	-21	4 020	4010	-10
<i>Excise duties</i>	4 064	4 244	-180	4 815	4615	-200
<i>Social contributions (PRSI) <sup>1</sup></i>	6 128	6 504	-376	7 087	6632	-455
<i>Other taxes</i>	2 061	1 981	80	2 245	2310	65
<b>Non-tax Revenue</b>	<b>2 713</b>			<b>2 730</b>	<b>2770</b>	<b>40</b>
<i>Central Bank Surplus Income</i>	958			945	958	13
<i>Bank Guarantee Fees</i>	1 025			982	1025	43
<i>National Lottery Surplus</i>	175			220	220	0
<i>Interest on contingent capital notes</i>	300			300	300	0
<i>Other</i>	255			283	267	-16
<b>Capital receipts <sup>2</sup></b>	<b>869</b>			<b>1 100</b>	<b>1314</b>	<b>214</b>
<i>EU agricultural funds (FEOGA)</i>	720			720	720	0
<i>Sale of Mobile Telephony Licences</i>	0			178	435	257
<i>Other</i>	149			202	159	-43
<b>Expenditure</b>	<b>54 167</b>			<b>60 341</b>	<b>60 072</b>	<b>-269</b>
<b>Current voted (net)</b>	<b>44 316</b>	<b>44 039</b>	<b>277</b>	<b>47 881</b>	<b>48322</b>	<b>441</b>
<i>Social Protection <sup>1</sup></i>	19 017	18 779	238	20 474	20704	230
<i>Health</i>	11 592	11 226	366	12 095	12456	361
<i>Education</i>	6 883	6 919	-36	7 635	7635	0
<i>Other</i>	6 824	7 115	-291	7 676	7526	-150
<b>Current non-voted <sup>2</sup></b>	<b>7 279</b>			<b>7 984</b>	<b>7469</b>	<b>-515</b>
<i>Debt Service</i>	5 810	6 076	-266	6 318	5845	-473
<i>EU Budget Contribution</i>	1 270			1 340	1390	50
<i>Other non-voted (ex-SF)</i>	199			326	234	-92
<b>Capital expenditure</b>	<b>2 572</b>			<b>4 476</b>	<b>4281</b>	<b>-195</b>
<i>Exchequer capital funding (net)</i>	2 446	2 851	-405	3635	3520	-115
<i>FEOGA and other EU payments</i>	125			830	760	-70
<i>Other</i>	1			11	1	-10
<b>Main below-the-line financial transfers</b>	<b>2 284</b>			<b>2 534</b>	<b>2541</b>	<b>7</b>
<i>Promissory Notes <sup>3</sup></i>	25			25	25	0
<i>Loans to Insurance Compensation Fun.</i>	450			450	456	6
<i>Irish Life Limited</i>	1 300			1300	1300	0
<i>ESM capital payment</i>	510			509	510	1
<i>Credit Union Funding</i>				250	250	0
<b>Exchequer balance <sup>3</sup></b>	<b>-12 968</b>			<b>-15 583</b>	<b>-15 732</b>	<b>-149</b>
<i>Below-the-line financial transfers</i>				2534	2541	7
<i>Local government sector</i>				-200	-125	75
<i>Accrual adjustments and other below-the-line operations</i>				146	11	-135
<b>General government balance <sup>4</sup></b>				<b>-13 103</b>	<b>-13 305</b>	
% of GDP				-8.1	-8.2	

Sources: End-November Exchequer statement; Stability Programme; 2012 budget; White Paper; 2013 budget and Commission Services estimates

Notes:

1 Social contributions (PRSI) are included among tax revenue and excluded from net Social Protection current expenditure. Net current expenditure are net of departmental own receipts (appropriations-in-aid).

2 Excludes Sinking Fund transfer from current to capital account, which is the Exchequer deficit neutral.

3 Excludes promissory note repayment to IBRC of EUR 3.06 billion, which was financed through a government bond placement.

4 The deficit-to-GDP ratios are calculated using the current 2012 GDP estimate of EUR 162.3 billion.

**Table A3: Use and supply of goods and services (volume)**

<i>Annual % change</i>	2010	2011	2012	2013	2014	2015
1. Private consumption expenditure	0.5	-2.3	-2.1	-0.5	1.2	1.8
2. Government consumption expenditure	-4.6	-4.3	-4.0	-1.7	-3.0	-3.3
3. Gross fixed capital formation	-22.7	-12.2	-4.0	-1.5	3.0	5.2
<b>4. Final domestic demand</b>	<b>-5.0</b>	<b>-4.2</b>	<b>-2.8</b>	<b>-1.0</b>	<b>0.5</b>	<b>1.1</b>
5. Change in inventories						
<b>6. Domestic demand</b>	<b>-4.4</b>	<b>-3.7</b>	<b>-2.8</b>	<b>-0.9</b>	<b>0.4</b>	<b>1.1</b>
7. Exports of goods and services	6.2	5.1	2.8	3.2	4.2	4.5
7a. - of which goods	5.3	2.7	2.2	3.2	4.2	4.5
7b. - of which services	7.2	7.7	3.4	3.2	4.2	4.5
<b>8. Final demand</b>	<b>1.1</b>	<b>1.2</b>	<b>0.4</b>	<b>1.5</b>	<b>2.7</b>	<b>3.2</b>
9. Imports of goods and services	3.6	-0.3	0.3	2.0	3.2	3.6
9a. - of which goods	-1.1	-2.3	0.3	2.0	3.2	3.6
9b. - of which services	6.5	0.8	0.3	2.0	3.3	3.7
<b>10. Gross domestic product at market prices</b>	<b>-0.8</b>	<b>1.4</b>	<b>0.4</b>	<b>1.1</b>	<b>2.2</b>	<b>2.8</b>
<i>Contribution to change in GDP</i>						
11. Final domestic demand	-4.3	-3.4	-2.2	-0.7	0.3	0.8
12. Change in inventories + net acq. of valuables	0.6	0.4	0.0	0.0	0.0	0.0
13. External balance of goods and services	2.9	5.4	2.6	1.8	1.9	2.0

**Table A4: Use and supply of goods and services (value)**

<i>Annual % change</i>	2010	2011	2012	2013	2014	2015
1. Private consumption expenditure	-1.6	-0.8	-0.2	0.8	2.7	3.4
2. Government consumption expenditure	-8.8	-2.8	-2.1	-0.8	-2.0	-2.6
3. Gross fixed capital formation	-26.9	-13.9	-2.5	2.6	7.5	10.3
<b>4. Final domestic demand</b>	<b>-8.0</b>	<b>-3.2</b>	<b>-1.0</b>	<b>0.7</b>	<b>2.2</b>	<b>3.0</b>
5. Change in inventories	-66.1	-139.4	-2.0	3.0	-11.0	0.0
<b>6. Domestic demand</b>	<b>-7.4</b>	<b>-2.7</b>	<b>-1.0</b>	<b>0.7</b>	<b>2.2</b>	<b>3.0</b>
7. Exports of goods and services	7.8	5.7	3.8	4.3	5.2	5.8
<b>8. Final demand</b>	<b>2.5</b>	<b>-1.9</b>	<b>3.7</b>	<b>2.8</b>	<b>4.0</b>	<b>4.7</b>
9. Imports of goods and services	6.6	2.8	1.3	3.3	4.4	4.9
10. Gross national income at market prices	-3.3	-2.2	0.2	1.6	3.5	3.3
11. Gross value added at basic prices	-1.9	2.4	1.0	2.5	3.4	4.4
<b>12. Gross domestic product at market prices</b>	<b>-3.0</b>	<b>1.6</b>	<b>2.1</b>	<b>2.4</b>	<b>3.7</b>	<b>4.4</b>

**Table A5: Implicit price deflators**

<i>% change in implicit price deflator</i>	2010	2011	2012	2013	2014	2015
1. Private consumption expenditure	-2.1	1.5	1.9	1.3	1.4	1.6
2. Government consumption expenditure	-4.3	1.6	2.0	1.0	1.0	0.8
3. Gross fixed capital formation	-5.4	-2.0	1.6	4.2	4.4	4.8
<b>4. Domestic demand</b>	<b>-3.1</b>	<b>1.1</b>	<b>1.9</b>	<b>1.6</b>	<b>1.7</b>	<b>1.9</b>
5. Exports of goods and services	1.6	0.6	1.0	1.1	1.0	1.2
<b>6. Final demand</b>	<b>-0.6</b>	<b>0.8</b>	<b>1.4</b>	<b>1.3</b>	<b>1.3</b>	<b>1.4</b>
7. Imports of goods and services	2.9	3.1	1.0	1.2	1.1	1.3
<b>8. Gross domestic product at market prices</b>	<b>-2.2</b>	<b>0.2</b>	<b>1.7</b>	<b>1.3</b>	<b>1.4</b>	<b>1.6</b>
<b>HICP</b>	<b>-1.6</b>	<b>1.2</b>	<b>2.0</b>	<b>1.3</b>	<b>1.4</b>	<b>1.6</b>

**Table A6: Labor market and labor costs**

<i>Annual % change</i>	2010	2011	2012	2013	2014	2015
1. Labour productivity	3.6	3.6	1.7	1.0	1.2	0.9
2. Compensation of employees per head	-1.5	2.1	0.7	0.0	0.1	0.1
3. Unit labour costs	-5.4	2.2	0.2	-1.1	-0.9	-0.8
4. Total population	0.3	0.2	0.4	0.7	0.9	1.0
5. Population of working age (15-64 years)	-0.8	-1.0	-0.9	-0.5	-0.1	0.1
6. Total employment	-4.1	-2.1	-1.2	0.0	0.9	1.9
7. Calculated unemployment rate - Eurostat definition (%)	13.7	14.4	14.8	14.7	14.2	13.4

**Table A7: External balance**

<i>levels</i>	2010	2011	2012	2013	2014	2015
1. Exports of goods (fob)	82.6	84.9	87.5	91.5	96.3	101.8
2. Imports of goods (fob)	46.9	48.3	48.9	50.5	52.7	55.3
<b>3. Trade balance (goods, fob/fob) (1-2)</b>	<b>35.8</b>	<b>36.6</b>	<b>38.6</b>	<b>41.0</b>	<b>43.5</b>	<b>46.5</b>
<i>3a. p.m. (3) as % of GDP</i>	22.8	23.0	23.8	24.7	25.3	25.8
4. Exports of services	75.2	81.9	85.5	89.0	93.7	99.2
5. Imports of services	81.5	83.6	84.7	87.5	91.3	95.9
<b>6. Services balance (4-5)</b>	<b>-6.3</b>	<b>-1.7</b>	<b>0.8</b>	<b>1.6</b>	<b>2.4</b>	<b>3.3</b>
<i>6a. p.m. 6 as % of GDP</i>	-4.0	-1.1	0.5	0.9	1.4	1.8
<b>7. External balance of goods &amp; services (3+6)</b>	<b>29.5</b>	<b>34.9</b>	<b>39.5</b>	<b>42.5</b>	<b>45.9</b>	<b>49.7</b>
<i>7a. p.m. 7 as % of GDP</i>	18.8	22.0	24.3	25.6	26.7	27.7
8. Balance of primary incomes and current	-27.5	-34.2	-35.8	-36.9	-38.4	-41.6
<i>8a. - of which, balance of primary income</i>	-25.2	-32.0	-35.0	-36.8	-38.4	-41.5
<i>8b. - of which, net current Transfers</i>	-2.3	-2.2	-0.7	0.0	0.0	-0.1
<i>8c. p.m. 8 as % of GDP</i>	-17.6	-21.5	-22.0	-22.2	-22.3	-23.1
<b>9. Current external balance (7+8)</b>	<b>2.0</b>	<b>0.7</b>	<b>3.7</b>	<b>5.7</b>	<b>7.5</b>	<b>8.1</b>
<i>9a. p.m. 9 as % of GDP</i>	1.3	0.5	2.3	3.4	4.4	4.5
10. Net capital transactions	-0.7	-0.4	-0.3	-0.2	-0.1	0.0
<b>11. Net lending (+)/ net borrowing (-) (9+10)</b>	<b>1.3</b>	<b>0.3</b>	<b>3.4</b>	<b>5.5</b>	<b>7.4</b>	<b>8.1</b>
<i>11a. p.m. 11 as % of GDP</i>	0.8	0.2	2.1	3.3	4.3	4.5

**Table A8: Fiscal accounts**

	2008	2009	2010	2011	2012	2013	2014	2015
	<i>% of GDP</i>							
Indirect taxes	12.4	11.3	11.5	11.1	11.1	11.0	11.2	11.2
Direct taxes	11.5	10.8	10.7	12.1	12.6	13.1	13.4	13.6
Social contributions	6.8	7.4	7.3	6.4	5.9	5.7	5.6	5.4
Sales	2.3	2.8	3.3	3.2	2.5	2.0	1.9	1.9
Other current revenue	1.3	1.3	1.4	1.3	1.4	1.4	1.3	1.1
<b>Total current revenue</b>	<b>34.5</b>	<b>33.7</b>	<b>34.2</b>	<b>34.2</b>	<b>33.5</b>	<b>33.2</b>	<b>33.4</b>	<b>33.3</b>
Capital transfers received	1.2	1.0	1.0	0.7	0.7	0.8	0.7	0.5
<b>Total revenue</b>	<b>35.7</b>	<b>34.7</b>	<b>35.2</b>	<b>34.9</b>	<b>34.3</b>	<b>34.0</b>	<b>34.2</b>	<b>33.7</b>
Compensation of employees	11.9	12.8	12.3	12.0	11.6	11.1	10.5	9.9
Intermediate consumption	5.8	6.4	6.0	5.6	5.3	4.8	4.3	3.8
Social transfers in kind via market producers	2.2	2.3	2.5	2.4	2.2	1.9	1.7	1.5
Social transfers other than in kind	11.6	14.5	14.8	15.0	14.4	13.7	12.8	12.3
Interest paid	1.3	2.0	3.2	3.3	4.0	5.7	5.6	5.5
Subsidies	0.5	0.6	0.6	0.4	0.3	0.3	0.3	0.2
Other current expenditure	2.5	2.6	2.3	2.1	2.2	2.2	2.1	2.0
<b>Total current expenditure</b>	<b>35.9</b>	<b>41.3</b>	<b>41.6</b>	<b>40.9</b>	<b>40.0</b>	<b>39.7</b>	<b>37.3</b>	<b>35.3</b>
Gross fixed capital formation	5.3	3.8	3.5	2.5	2.0	1.6	1.5	1.5
Other capital expenditure	1.9	3.6	21.0	4.8	0.7	0.2	0.3	0.2
<b>Total expenditure</b>	<b>43.1</b>	<b>48.7</b>	<b>66.1</b>	<b>48.2</b>	<b>42.6</b>	<b>41.5</b>	<b>39.1</b>	<b>37.0</b>
<b>General Government balance (EDP)</b>	<b>-7.4</b>	<b>-13.9</b>	<b>-30.9</b>	<b>-13.4</b>	<b>-8.4</b>	<b>-7.5</b>	<b>-5.0</b>	<b>-3.3</b>
	<i>EUR billion</i>							
Indirect taxes	22.2	18.3	17.9	17.7	18.0	18.3	19.3	20.2
Direct taxes	20.7	17.4	16.7	19.2	20.5	21.7	23.1	24.5
Social contributions	12.2	12.0	11.5	10.3	9.6	9.5	9.7	9.8
Sales	4.2	4.5	5.2	5.1	4.1	3.4	3.3	3.3
Other current revenue	2.3	2.1	2.2	2.1	2.3	2.3	2.2	2.0
<b>Total current revenue</b>	<b>61.7</b>	<b>54.3</b>	<b>53.6</b>	<b>54.3</b>	<b>54.4</b>	<b>55.2</b>	<b>57.6</b>	<b>59.8</b>
Capital transfers received	2.2	1.7	1.6	1.1	1.2	1.3	1.3	0.8
<b>Total revenue</b>	<b>63.9</b>	<b>56.0</b>	<b>55.1</b>	<b>55.4</b>	<b>55.6</b>	<b>56.5</b>	<b>58.9</b>	<b>60.6</b>
Compensation of employees	21.2	20.7	19.3	19.1	18.8	18.4	18.1	17.8
Intermediate consumption	10.4	10.4	9.3	8.9	8.6	8.0	7.4	6.9
Social transfers in kind via market producers	3.9	3.8	3.9	3.8	3.5	3.2	3.0	2.8
Social transfers other than in kind	20.8	23.4	23.2	23.8	23.4	22.8	22.1	22.1
Interest paid	2.4	3.3	5.0	5.3	6.5	9.4	9.7	9.9
Subsidies	0.9	0.9	0.9	0.6	0.5	0.5	0.4	0.4
Other current expenditure	4.5	4.3	3.5	3.4	3.6	3.6	3.6	3.7
<b>Total current expenditure</b>	<b>64.2</b>	<b>66.7</b>	<b>65.1</b>	<b>65.0</b>	<b>65.0</b>	<b>65.9</b>	<b>64.3</b>	<b>63.5</b>
Gross fixed capital formation	9.5	6.1	5.5	4.0	3.2	2.7	2.7	2.7
Other capital expenditure	3.3	5.7	32.8	7.6	1.1	0.4	0.5	0.4
<b>Total expenditure</b>	<b>77.0</b>	<b>78.5</b>	<b>103.4</b>	<b>76.7</b>	<b>69.2</b>	<b>69.0</b>	<b>67.4</b>	<b>66.6</b>
<b>General Government balance (EDP)</b>	<b>-13.2</b>	<b>-22.5</b>	<b>-48.3</b>	<b>-21.3</b>	<b>-13.6</b>	<b>-12.5</b>	<b>-8.6</b>	<b>-5.9</b>

**Table A9: Debt developments**

	2008	2009	2010	2011	2012	2013	2014	2015
<b>EDP deficit (% of GDP)</b>	<b>-7.4</b>	<b>-13.9</b>	<b>-30.9</b>	<b>-13.4</b>	<b>-8.4</b>	<b>-7.5</b>	<b>-5.0</b>	<b>-3.3</b>
EDP gross debt (% of GDP)	44.5	64.9	92.2	106.4	117.5	122.1	119.2	117.3
<i>levels, EUR billion</i>								
<b>EDP deficit</b>	<b>-13.2</b>	<b>-22.5</b>	<b>-48.3</b>	<b>-21.3</b>	<b>-13.6</b>	<b>-12.5</b>	<b>-8.6</b>	<b>-5.9</b>
Gross debt	79.6	104.6	144.2	169.2	190.8	202.9	205.3	211.0
Change in gross debt	32.4	25.0	39.6	25.0	21.5	12.1	2.4	5.7
Nominal GDP	178.9	161.3	156.5	159.0	162.3	166.2	172.3	179.9
Real GDP	177.4	167.7	166.4	168.8	169.5	171.3	175.1	179.9
<b>Real GDP growth (% change)</b>	<b>-2.1</b>	<b>-5.5</b>	<b>-0.8</b>	<b>1.4</b>	<b>0.4</b>	<b>1.1</b>	<b>2.2</b>	<b>2.8</b>
Change in gross debt (% of GDP)	18.1	15.5	25.3	15.7	13.3	7.3	1.4	3.2
Stock-flow adjustments (% of GDP)	10.8	1.6	-5.6	2.4	4.9	-0.2	-3.6	-0.1
<i>% of GDP</i>								
<b>Gross debt ratio</b>	<b>44.5</b>	<b>64.9</b>	<b>92.2</b>	<b>106.4</b>	<b>117.5</b>	<b>122.1</b>	<b>119.2</b>	<b>117.3</b>
Change in gross debt ratio	19.5	20.4	27.3	14.3	11.1	4.6	-2.9	-1.9
<i>Contribution to change in gross debt</i>								
Primary balance	6.0	11.9	27.7	10.0	4.4	1.9	-0.7	-2.2
"Snow-ball" effect	2.7	7.0	5.2	1.9	1.8	2.9	1.3	0.5
of which								
<i>Interest expenditure</i>	<i>1.3</i>	<i>2.0</i>	<i>3.2</i>	<i>3.3</i>	<i>4.0</i>	<i>5.7</i>	<i>5.6</i>	<i>5.5</i>
<i>Real growth effect</i>	<i>0.6</i>	<i>2.7</i>	<i>0.5</i>	<i>-1.3</i>	<i>-0.4</i>	<i>-1.2</i>	<i>-2.6</i>	<i>-3.2</i>
<i>Inflation effect</i>	<i>0.8</i>	<i>2.3</i>	<i>1.5</i>	<i>-0.2</i>	<i>-1.7</i>	<i>-1.5</i>	<i>-1.7</i>	<i>-1.8</i>
<b>Stock-flow adjustments</b>	<b>10.8</b>	<b>1.6</b>	<b>-5.6</b>	<b>2.4</b>	<b>4.9</b>	<b>-0.2</b>	<b>-3.6</b>	<b>-0.1</b>
<i>Implicit interest rate</i>	<i>5.1</i>	<i>4.1</i>	<i>4.8</i>	<i>3.7</i>	<i>3.8</i>	<i>4.9</i>	<i>4.8</i>	<i>4.8</i>

## Notes:

The projections for gross debt incorporate the completion of the outstanding financial sector capital injections in 2012 (in the amount of EUR 1.6 billion) and other smaller financial transactions. The projections assume no use of precautionary contingencies foreseen in the programme's financing plan and cash balances declining from EUR 17 billion at end-2013 and to EUR 9 billion by 2015.



## **Annex 3: Draft updated programme documents**

### **Ireland**

#### **Letter of Intent**

Dublin, 29 November 2012

Mr Mario Draghi  
President  
European Central Bank  
Kaiserstrasse 29  
60311 Frankfurt am Main  
Germany

Mr Jean-Claude Juncker  
Eurogroup President  
Ministère des Finances  
3, rue de la Congrégation  
L-1352  
Luxembourg

Mr Olli Rehn  
Vice-President of the European Commission responsible for Economic and Monetary  
Affairs and the euro  
European Commission  
BERL 10/299  
B-1049 Brussels  
Belgium

Mr Vassos Shiarly  
Minister of Finance  
Michael Karaoli & Gregori Afxentiou  
1439 Nicosia  
Cyprus

Dear Messrs Draghi, Juncker, Rehn, and Shiarly

1. The Irish Government remains firmly committed to the programme, as illustrated by our continued strong performance in implementing the agreed policy frameworks and

measures. This performance, and our preparation for Budget 2013, is against a backdrop of an increasingly adverse international economic environment. Nevertheless, yields on Irish government bonds have fallen dramatically in recent months, reflecting our strong performance as well as certain positive developments in Europe, especially the euro area leaders' June 29 commitment to decouple the sovereign and banking debt issues and in this context to specifically examine the situation of the Irish financial sector with the view of improving the sustainability of Ireland's well-performing adjustment programme. The ECB's decision on Outright Monetary Transactions is another positive development. These improved market conditions enabled the launch of our first bond issue under the programme in late July and the renewal of regular Treasury bill auctions. As we enter the final year of our 3yr programme, we are now focusing on the measures necessary to successfully exit from the programme. Notwithstanding the external risks, our policy efforts are aimed at further deepening our access to market funding during 2013, in order to exit from reliance on official financing. Timely implementation of euro area leaders' commitments would greatly support the effectiveness of these efforts. We are sure that we can rely on continued support of the external partners and fellow member states in this endeavour.

2. For the eighth review, we have once again met our commitments under the EU/IMF supported programme in terms of policy reforms as well as quantitative targets:

- As regards our fiscal consolidation objectives, the 2012 cumulative exchequer balance through end-September was ahead of the programme profile and, for 2012 as a whole, the general government deficit is projected to be below the 8.6% of GDP programme ceiling. We are alert to the overruns experienced in the health sector, and are taking structural measures to correct them in a durable manner. We will also present Budget 2013 to the Dail on December 5, which will underpin our commitment to reduce the general government deficit in 2013 and future years in line with our agreed programme consolidation path, despite the weaker growth outlook.
- We have introduced legislation to the Dail by end-September as envisaged, including measures to: (i) reform the personal insolvency framework; (ii) establish a Central Credit Register; (iii) strengthen the Credit Union legislative framework; and provide the legal basis for, respectively, (iv) the Irish Fiscal Advisory

Council and (v) the medium-term expenditure ceilings (both introduced last year on an administrative basis). We have also launched an advisory service for distressed mortgage borrowers and introduced on a statutory basis (i) the requirement, under the terms of the Deposit Guarantee Scheme, for Credit Unions to maintain an amount in the Deposit Protection account in the central bank and (ii) a levy to fund the credit institutions resolution fund. Moreover, we progressed on reforming activation policies and preparing identified non-strategic state assets for eventual disposal, and reforming the sectoral wage setting mechanisms (legislation for which has been approved). Finally, we are taking necessary steps to introduce water meters, centralize the provision of water services and ensure a sound financial footing for Irish Water according to the timeline envisaged under the programme.

- The overarching strengthening, restructuring, and right-sizing of the domestic banking and the credit union sectors are also progressing according to plan. Two out of three PCAR banks are well advanced in reaching their end-2013 asset deleverage targets, and the Central Bank has formalized to the PCAR banks non-core asset deleverage targets and has introduced an advanced monitoring framework designed to ensure the banks take actions to improve net-stable-funding and liquidity coverage ratios. Revised restructuring plans for both AIB and PTSB have been submitted to the European Commission. Further actions to address loan arrears and unsustainable debts in banks' mortgage and SME loan portfolios are being implemented.

3. In light of our performance under the programme and our continued commitment to it, we request the completion of the eighth review and the release of the eighth EFSF/EFSM disbursement of EUR 0.8 billion.

4. In the attached seventh update of the Memorandum of Understanding of Specific Economic Policy Conditionality (the MOU), as well as in the Memorandum of Economic and Financial Policies (MEFP), we set out our plans to further advance towards meeting the objectives of our economic adjustment programme. We also continue to work with staff of the European Commission, the European Central Bank and the International Monetary Fund on the follow-up to the 29 June statement by the Heads of State and Government of the euro area.

5. We consider that delivering in full our commitments under the programme, while progressing towards severing the pernicious link between the banks and the sovereign, will enable Ireland to successfully exit the programme and return to sustained private market funding.

6. We are confident that the policies set forth in the Letters of Intent of 3 December 2010 and subsequent letters as well as this letter are adequate to achieve the objectives of our Programme. At the same time, while we do not envisage that revisions will be needed, we stand ready to take any corrective actions that may become appropriate if circumstances change. We will continue to consult with staff of the European Commission, the ECB, and the IMF on the adoption of such actions in advance in the event that revision of the policies contained in this Letter and the attached Memoranda becomes necessary.

7. This letter is being copied to Mme Lagarde.

Sincerely,

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Michael Noonan, T.D.

Minister for Finance  
Ireland

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Patrick Honohan

Governor of the Central Bank of

**Ireland**  
**Memorandum of Understanding**  
**On**  
**Specific Economic Policy Conditionality**  
**(Seventh Update)**  
**[XX] January 2013**  
**DRAFT**

1. With regard to Council Regulation (EU) n° 407/2010 of 11 May 2010 establishing a European Financial Stabilisation Mechanism (EFSM), and in particular Article 3(5) thereof, this seventh update of the Memorandum of Understanding on Specific Economic Policy Conditionality (MoU) details the general economic policy conditions as embedded in Council Implementing Decision 2011/77/EU of 7 December 2010 on granting Union financial assistance to Ireland.
2. The quarterly disbursement of financial assistance from the EFSM<sup>39</sup> will be subject to quarterly reviews of conditionality for the duration of the programme. Release of the instalments will be based on observance of quantitative performance criteria, respect for EU Council Decisions and Recommendations in the context of the excessive deficit procedure (EDP), and a positive evaluation of progress made with respect to policy criteria in the Memorandum of Economic and Financial Policies (MEFP) and this updated MoU, which details and further specifies the criteria that will be assessed for the successive reviews up to the end of 2013. If targets are expected to be missed, additional action will be taken.
3. For the duration of the EU/IMF financial assistance programme the Irish authorities will take all the necessary measures to ensure a successful implementation of the programme and minimise the costs to the taxpayers, while protecting the most vulnerable. In particular, they commit to:

Rigorously implement fiscal policy consistent with the requirements of the excessive deficit procedure. In particular, the Department of Finance and the Department of Public Expenditure and Reform will continue to ensure effective tax collection and tight supervision of expenditure commitments by the line departments to ensure that the primary deficit target in cash (see Table 1 of MEFP and the Technical Memorandum of Understanding, TMU) and the general Government nominal budget deficit on ESA95 basis as set out in the EU Council Recommendation on excessive deficit procedures are achieved. Any additional unplanned revenues must be allocated

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<sup>39</sup> On 28 November 2010 Eurogroup and ECOFIN Ministers issued a statement clarifying that euro-area and EU financial support will be provided on the basis of the programme which has been negotiated with the Irish authorities by the Commission and the IMF, in liaison with the ECB. Further to the Union support from the EFSM, loans from the EU and its Member States will include contributions from the European Financial Stability Facility (EFSF) and bilateral lending support from the United Kingdom, Sweden, and Denmark. The Loan Facility Agreements on these financing contributions will specify that the disbursements there under are subject to the compliance with the conditions of this Memorandum.

to debt reduction. Moreover, the nominal value of Social Welfare pensions will not be increased.

Continue to strengthen the fiscal framework and reporting in line with EU requirements.

Use at least half of the proceeds from state asset sales for eventual debt reduction while also reinvesting the remainder of the total realised proceeds in projects which are of a commercial nature, meet ex-ante cost benefit criteria, enhance employment and preserve long term fiscal sustainability, including Programme and EDP fiscal targets.

Continuously monitor financial markets to exploit opportunities to return to commercial funding as soon as possible.

Ensure that activation services are enhanced, to tackle the high and persistent rate of long-term unemployment. In particular, the Department of Social Protection will take steps to improve the ratio of vacancies filled off the live register, focus on re-training the unemployed to reduce the risk of long-term unemployment and ensure appropriate incentives through the implementation of sanctions. Generally, the government will advance its plans to introduce new activation measures building on *Pathways to Work* (the government's strategy for institutional reform of the activation system).

Ensure that no further exemptions to the competition law framework will be granted unless they are entirely consistent with the goals of the EU/IMF Programme and the needs of the economy.

Ensure that NAMA: (i) maintains the highest standards of governance with appropriate accountability and transparency arrangements; (ii) reduces the costs of its operations; and (iii) constructively contributes to the restoration of the Irish property market in the course of meeting the asset disposal targets established and monitored by the NAMA Board, including redemption of €7.5 billion worth of senior bonds by end 2013.

Ensure that the restructuring of credit unions will underpin the financial stability and long term sustainability of the sector. The restructuring will be completed in as short a timeframe as possible under a clear plan identifying credit unions appropriate for restructuring, subject to Central Bank regulatory approval. As regards funding, the first call should be on the credit unions concerned or the sector as a whole; any Exchequer funding should be minimised, should be provided only in the context of a restructuring plan in compliance with EU state aid rules, and should be recouped from the sector over time. In parallel, the Central Bank will continue its inspections to determine the financial condition of the weakest credit unions, and will engage its resolution powers as needed, drawing on Resolution Fund resources if required.

Ensure continued compliance with the minimum Core Tier 1 Capital ratio of 10.5% for all PCAR banks (AIB, BOI, and PTSB).

Consult ex-ante with the European Commission, the ECB and the IMF on the adoption of policies that are not included in this Memorandum but that could have a material impact on the achievement of programme objectives.

4. To facilitate programme monitoring, the authorities will provide the European Commission, the ECB and the IMF with:

a. All information required to monitor progress during programme implementation and to track the economic and financial situation.

A compliance report on the fulfilment of the conditionality prior to the release of the instalments.

Reliable and regular availability of budgetary and other data as detailed in Annex 1.

## 1. Actions for the ninth review (actions to be completed by end Q4-2012)

### Fiscal consolidation

5. The Government will publish a budget for 2013 consistent with a general government deficit ceiling of 7.5% of GDP and in line with the Council Recommendations under Ireland's excessive deficit procedure.
6. On the basis of the aggregate budgetary projections set out in the Medium Term Fiscal Statement (MTFS) of November 2011, consolidation measures for 2013 will amount to at least €3.5 billion. The following measures are proposed for 2013 on the basis of the MTFS:
  - Revenue measures to raise at least €1.25 billion<sup>40</sup>, including:
    - A broadening of personal income tax base.
    - A value-based property tax.
    - A restructuring of motor taxation.
    - A reduction in general tax expenditures.
    - An increase in excise duty and other indirect taxes.
  - Expenditure reductions necessary to achieve an upper limit on voted expenditure of €54.3 billion, which will involve deficit consolidation measures of €2.25 billion on the basis of the MTFS, including:
    - Social expenditure reductions.
    - Reduction in the total pay and pensions bill.
    - Other programme expenditure, and reductions in capital expenditure.
7. Without prejudice to the minimum consolidation amount referred to in the previous paragraph and to the requirements to achieve the agreed fiscal targets, the Government may, in consultation with the staff of the European Commission, the IMF, and the ECB, substitute one or more of the above measures with others of equally good quality based on the options identified in the Comprehensive Review of Expenditure (CRE).
8. The authorities will take the measures necessary to unwind the overrun in health spending and will contain health expenditure next year to within the €13.6 billion departmental ceiling for 2013 set in the *Comprehensive Expenditure Report 2012-14*.

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<sup>40</sup> Inclusive of carryover from 2012.

9. Government will publish a medium-term fiscal statement covering the period 2013-2015 consistent with a further reduction of the General Government deficit in line with the fiscal targets set out in the Council Recommendation in the context of the excessive deficit procedure.
10. DPER and DECLG will agree a protocol to ensure that the local government sector continues to be managed in balance over the medium term and in particular to ensure a balanced budget in 2013, by reference to the application of the financial management safeguards and requirements in place within the sector.

## **Financial sector reforms**

### *Capital assessment*

11. The authorities will provide the staff of the European Commission, the ECB and the IMF a review of developments in the PCAR banks relative to PCAR 2011. Overall results of this work will be published by end January 2013. The authorities will agree with the staff of the European Commission, the ECB and the IMF on the specific details of the review.

### *Deleveraging*

12. The authorities, in consultation with the staff of the European Commission, the IMF, and the ECB, will assess banks' deleveraging based on the existing nominal targets for disposal and run-off of non-core assets in line with the 2011 Financial Measures Programme. Fire sales of assets will be avoided, as will any excessive deleveraging of core portfolios, so as not to impair the flow of credit to the domestic economy.

### *Funding and liquidity monitoring*

13. The authorities will provide staff of the European Commission, the IMF, and the ECB with a detailed assessment of banks' progress towards the relevant Basel III requirements using the advanced monitoring framework.

### *Asset quality*

14. The authorities will provide staff of the European Commission, the IMF, and the ECB with their assessment of banks' performance with the work-out of their non-performing mortgage portfolios in accordance with the agreed key performance indicators. A set of key performance indicators for SMEs will also be developed. The authorities will monitor each PCAR bank's performance relative to already-defined key performance indicators for progress in resolving problem loans, and also against bank specific targets for reviewing new and existing individual arrears cases.
15. The authorities will publish banks' reported data on loan modifications, including re-defaults of modified loans, to permit analysis of the effectiveness of alternative resolution approaches in improving debt service performance.

### *Reorganisation*



16. The authorities will report on progress in implementing the strategy for the reorganisation of Irish credit institutions, including any steps to strengthen the credit union sector, and discuss it together with the staff of the European Commission, the IMF, and the ECB.

### *Financial Supervision*

17. The authorities will present a comprehensive report on progress in implementing the Central Bank of Ireland's action plan for strengthening supervision of credit institutions and discuss it together with the staff of the European Commission, the ECB and the IMF.
18. The authorities will report on banks' progress with the implementation of their strategies to address loan arrears and unsustainable debts in banks' mortgage and SME loan portfolios.
19. The authorities will continue enhancing their approach to Credit Risk, risk weighted asset (RWA) supervision including conducting annual model performance reviews, assessing RWA calculation and reviewing banks' approaches to RWA forecasting and stress testing in advance of PCAR 2013. The authorities will complete the reviews and issue mitigating actions for the banks concerned.

### *Personal Insolvency Reform*

20. The authorities will ensure that the Draft Personal Insolvency Bill will provide for the framework for the appropriate licensing and regulation of Personal Insolvency Practitioners.

## **Structural reforms**

### *Enhancing access to finance for SMEs*

21. The authorities will report on a survey of SMEs demand for credit covering the six months to September 2012. This will include whether or not SMEs sought credit, approval/refusal rates, conditions and criteria attached to approvals, reasons for refusals and information on use of non-bank finance, turnover, profitability and employment levels. In addition, the authorities will complete a separate study assessing the effectiveness of the Credit Review Office to ensure that SMEs are getting the support on bank lending they require.
22. The authorities will also improve the efficiency of the corporate insolvency framework for SMEs, drawing on the recommendations in the recent report by the Company Law Review Group. In particular, the authorities will prepare amendments to designate the Circuit Courts as competent for the examinership of companies within the EU small company thresholds (e.g., balance sheet below €4.4 million).

### *Competition*

23. On the basis of a report on developments to be provided by the authorities by end Q4 2012, the authorities, in consultation with staff of the European Commission, IMF and the ECB, will review whether sufficient progress has been made toward the goal of strengthening competition law enforcement by ensuring the availability of effective sanctions for infringements of Irish competition law and Articles 101 and 102 of the Treaty on the Functioning of the European Union and the functioning of the Competition Authority, and whether additional measures will be required.

### *State asset disposals*

24. Government will complete, if necessary, relevant regulatory, legislative, corporate governance and financial reforms required to bring to the point of sale the assets it has identified for disposal. For each asset and/or group of assets, the government will provide a report to the staff of the European Commission, the IMF, and the ECB on progress achieved and remaining steps towards to the point of sale.

### *Water services reform*

25. The authorities will ensure assignment of economic regulatory oversight over the water sector, including price setting powers, is provided for by way of legislation to the Commission for Energy Regulation. The Government will also ensure that interim arrangements are in place for the establishment of Irish Water.

## **2. Actions for the tenth review (actions to be completed by end Q1-2013)**

### **Financial sector reforms**

#### *Capitalisation*

26. The authorities will report on the evolution of regulatory capital within the PCAR banks up to the end of December 2012, and will present and discuss their findings with the staff of the European Commission, the IMF, and the ECB.

#### *Deleveraging*

27. The authorities, in consultation with the staff of the European Commission, the IMF, and the ECB, will assess banks' deleveraging based on the existing nominal targets for disposal and run-off of non-core assets in line with the 2011 Financial Measures Programme. Fire sales of assets will be avoided, as will any excessive deleveraging of core portfolios, so as not to impair the flow of credit to the domestic economy.

#### *Funding and liquidity monitoring*

28. The authorities will provide staff of the European Commission, the IMF, and the ECB with a detailed assessment of banks' progress towards the relevant Basel III requirements using the advanced monitoring framework.
29. Following finalisation of the Capital Requirements Directive legislative text, the authorities will establish draft guidance for the creation and subsequent holding of liquidity buffers by banks for issue in advance of the entry into force of the regulations.
30. In addition, the authorities will monitor the liquidity buffers held by banks in accordance with the Capital Requirements Regulation.

### *Asset quality*

31. The authorities will provide staff of the European Commission, the IMF, and the ECB with their assessment of banks' performance with the work-out of their non-performing mortgage and SME portfolios in accordance with the agreed key performance indicators. The authorities will monitor each PCAR bank's performance relative to already-defined key performance indicators for progress in resolving problem loans, and also against bank specific targets for reviewing new and existing individual arrears cases.
32. The authorities will publish banks' reported data on loan modifications, including re-defaults of modified loans, to permit analysis of the effectiveness of alternative resolution approaches in improving debt service performance.
33. Having secured adequate protections for debtors' principal private residence through the enactment of the Personal Insolvency Bill, the authorities will introduce legislation remedying the issues identified by case law in the 2009 Land and Conveyancing Law Reform Act, so as to remove unintended constraints on banks to realise the value of loan collateral under certain circumstances.

### *Reorganisation*

34. The authorities will report on progress in implementing the strategy for the reorganisation of Irish credit institutions, including any steps to strengthen the credit union sector, and discuss it with the staff of the European Commission, the IMF, and the ECB.

### *Financial supervision*

35. The authorities will present a comprehensive report on progress in implementing the Central Bank of Ireland's action plan for strengthening supervision of credit institutions and discuss it with the staff of the European Commission, the IMF, and the ECB.
36. The authorities will report on banks' progress with the implementation of their strategies to address loan arrears and unsustainable debts in banks' mortgage, and SME loan portfolios.
37. The authorities will ensure appropriately prudent provisioning treatment of loan modifications. The authorities will continue to engage with banks and review the proposed provisioning treatment for all advanced loan modification products being introduced as part of their mortgage arrears resolution strategies. In addition, the authorities will, in consultation with staff of the EC, ECB, and the IMF, update where necessary the 2011 Impairment Provisioning and Disclosure guidelines setting out the appropriate assumptions for all categories of advanced loan modifications.

## **Structural reforms**

### *Health sector*

38. The authorities will conduct a study to compare the cost of drugs, prescription practices and the usage of generics in Ireland with comparable EU jurisdictions.

### *Efficient social support expenditure*

39. The authorities will complete by end January a review of the labour market activation policies in place to enable the unemployed to return to active employment against the targets set out in the 'Pathways to Work' plan, with a view to increasing the impact of the interventions made and services provided in this key area through; implementing key service elements such as profile-based activation in all offices; extending one-stop shops to more offices, bringing forward necessary steps to outsource training and activation, and broadening coverage of policy initiatives to long-term unemployed.

## **3. Actions for the eleventh review (actions to be completed by end Q2-2013)**

## **Financial sector reforms**

### *Capital assessment*

40. The authorities will agree with the staff of the European Commission, the ECB and IMF on the specific features of the methodology for the PCAR 2013 stress test exercise.

### *Deleveraging*

41. The authorities, in consultation with the staff of the European Commission, the IMF, and the ECB, will assess banks' deleveraging based on the existing nominal targets for disposal and run-off of non-core assets in line with the 2011 Financial Measures Programme. Fire sales of assets will be avoided, as will any excessive deleveraging of core portfolios, so as not to impair the flow of credit to the domestic economy.

### *Funding and liquidity monitoring*

42. The authorities will provide staff of the European Commission, the IMF, and the ECB with a detailed assessment of banks' progress towards the relevant Basel III requirements using the advanced monitoring framework.
43. The authorities will also monitor the liquidity buffers held by banks in accordance with the Capital Requirements Regulation.

### *Asset quality*

44. The authorities will provide staff of the European Commission, the IMF, and the ECB with their assessment of banks' performance with the work-out of their non-performing mortgage and SME portfolios in accordance with the agreed key performance indicators. The authorities will monitor each PCAR bank's performance relative to already-defined key performance indicators for progress in resolving problem loans, and also against bank specific targets for reviewing new and existing individual arrears cases.
45. The authorities will publish banks' reported data on loan modifications, including re-defaults of modified loans, to permit analysis of the effectiveness of alternative resolution approaches in improving debt service performance.
46. The authorities will undertake a review of progress in addressing mortgage arrears.

### *Reorganisation*

47. The authorities will report on progress in implementing the strategy for the reorganisation of Irish credit institutions, including any steps to strengthen the credit union sector, and discuss it together with the staff of the European Commission, the IMF, and the ECB.

### *Financial supervision*

48. The authorities will present a comprehensive report on progress in implementing the Central Bank of Ireland's action plan for strengthening supervision of credit institutions and discuss it together with the staff of the European Commission, the IMF, and the ECB.
49. The authorities will report on banks' progress with the implementation of their strategies to address loan arrears and unsustainable debts in banks' mortgage, and SME loan portfolios.
50. The authorities will review the implementation of the 2011 CBI Provisioning and Disclosure guidelines by the covered banks with reference to the end-2012 published financial statements.
51. Upon publication of the EU directive establishing a framework for the recovery and resolution of credit institutions and investment firms, the authorities will review the Resolution fund levy regulation.

## **Structural reforms**

### *State assets*

52. The authorities will report to the staff of the European Commission, the IMF, and the ECB on the quantum of the proceeds of any realised asset sales to date. For assets yet to be disposed, the authorities will report on progress made and remaining steps.

### *Labour market reform*

53. The authorities will report to the staff of the European Commission, the IMF, and the ECB on the impact on the labour market of reforms to sectoral wage-setting mechanisms undertaken under the programme.

#### *Water services reform*

54. The Commission for Energy Regulation will carry out consultations to determine the framework for household water charges with a view to start charging by the end of the EU-IMF programme period. The CER will also conduct consultations in due course to determine the pricing methodology for the non-domestic sector.
55. The Government will publish a Water Services Bill with the aim of defining the regulatory framework for the water sector under a national public utility setting and providing for the establishment of Irish Water in its final form. There will be prior engagement with the European Commission as appropriate, in developing the legislative arrangements.

### **4. Actions for the twelfth review (actions to be completed by end Q3-2013)**

#### **Financial sector reforms**

##### *Capital assessment*

56. The authorities will complete the PCAR 2013. Building on the outcomes from PCAR 2011 and the FMP 2012, the authorities will conduct another rigorous stress test and this will continue to be based on robust loan-loss forecasts and a high level of transparency. This stress test will draw on an assessment of the banks' calculation of risk weighted assets, loan loss forecasting, and capital modelling. Before publication, the results of the PCAR 2013 will be discussed with the staff of European Commission, the IMF, and the ECB and will be aligned with the timing of the next EBA exercise. The results and methodology will be published in full and on a bank-by-bank basis, and the authorities will accordingly ensure that banks are adequately capitalised.
57. The authorities will report on the evolution of regulatory capital up to the end of June 2013 within the banks covered by the PCAR and will present and discuss their findings with the staff of the European Commission, the IMF, and the ECB.

##### *Deleveraging*

58. The authorities, in consultation with the staff of the European Commission, the IMF, and the ECB, will assess banks' deleveraging based on the existing nominal targets for disposal and run-off of non-core assets in line with the 2011 Financial Measures Programme. Fire sales of assets will be avoided, as will any excessive deleveraging of core portfolios, so as not to impair the flow of credit to the domestic economy.

##### *Funding and liquidity monitoring*

59. The authorities will provide staff of the European Commission, the IMF, and the ECB with a detailed assessment of banks' progress towards the relevant Basel III requirements using the advanced monitoring framework.

#### *Asset quality*

60. The authorities will provide staff of the European Commission, the IMF, and the ECB with their assessment of banks' performance with the work-out of their non-performing mortgage and SME portfolios in accordance with the agreed key performance indicators. The authorities will monitor each PCAR bank's performance relative to already-defined key performance indicators for progress in resolving problem loans, and also against bank specific targets for reviewing new and existing individual arrears cases.
61. The authorities will publish banks' reported data on loan modifications, including re-defaults of modified loans, to permit analysis of the effectiveness of alternative resolution approaches in improving debt service performance.

#### *Reorganisation*

62. The authorities will report on progress in implementing the strategy for the reorganisation of Irish credit institutions, including any steps to strengthen the credit union sector, and discuss it together with the European Commission, the IMF, and the ECB.

#### *Financial Supervision*

63. The authorities will present a comprehensive report on progress in implementing the Central Bank of Ireland's action plan for strengthening supervision of credit institutions and discuss it together with the staff of the European Commission, the IMF, and the ECB.
64. The authorities will report on banks' progress with the implementation of their strategies to address loan arrears and unsustainable debts in banks' mortgage and SME loan portfolios.

### **Structural reforms**

#### *Access to SME credit*

65. Based on experience of the operation of the Insolvency Service in the personal insolvency reform, the authorities will consider the appropriateness of further enhancements to the company law framework to reduce costs and achieve efficiency gains, including the potential for an administrative body to facilitate SME restructuring.

#### *Water services reform*

66. The Government's budgetary perspective will be based on Irish Water becoming substantially self-funded over time.



## **5. Actions for the thirteenth review (actions to be completed by end Q4-2013)**

### **Financial sector reforms**

#### *Deleveraging*

67. The authorities will produce a final report of the banks' implementation of their deleveraging plans under the PLAR 2011. Their compliance with the asset disposal and run-off targets in nominal value terms will be discussed with the staff of the European Commission, the IMF, and the ECB.
68. The authorities will produce a final report on progress towards compliance with Basel III liquidity and funding requirements by the relevant dates.
69. The authorities will also monitor the liquidity buffers held by banks in accordance with the Capital Requirements Regulation.

#### *Asset quality*

70. The authorities will provide staff of the European Commission, the IMF, and the ECB with their assessment of banks' performance with the work-out of their non-performing mortgage and SME portfolios in accordance with the agreed key performance indicators. The authorities will monitor each PCAR bank's performance relative to already-defined key performance indicators for progress in resolving problem loans, and also against bank specific targets for reviewing new and existing individual arrears cases.
71. The authorities will publish banks' reported data on loan modifications, including re-defaults of modified loans, to permit analysis of the effectiveness of alternative resolution approaches in improving debt service performance.

#### *Reorganisation*

72. The authorities will provide a final report on progress in implementing the strategy for the reorganisation of Irish credit institutions, including any steps to strengthen the credit union sector, and discuss it together with the European Commission, the IMF, and the ECB.

#### *Financial Supervision*

73. The authorities will present a final comprehensive report on progress in implementing the Central Bank of Ireland's action plan for strengthening supervision of credit institutions and discuss it together with the European Commission, the IMF, and the ECB.
74. The authorities will provide a final report on banks' progress with the implementation of their strategies to address loan arrears and unsustainable debts in banks' mortgage, and SME loan portfolios.
75. The authorities will ensure that the Central Credit Register is operational.

## Annex 1. Provision of data

During the programme, the following indicators and reports shall be made available to the staff of the European Commission, the IMF, and the ECB by the Irish authorities on a regular basis. The External Programme Compliance Unit (EPCU) of the Department of Finance will coordinate and collect data and information and forward to the staff of the European Commission, the IMF, and the ECB.

<b>To be provided by the Department of Finance in consultation with the Department of Public Expenditure and Reform as appropriate</b>		
Ref.	Report	Frequency
F.1	Monthly data on adherence to budget targets (Exchequer statement, details on Exchequer revenues and expenditure with information on Social Insurance Fund to follow as soon as practicable).	Monthly, 10 days after the end of each month
F.2	Updated monthly report on the Exchequer Balance and General Government Balance outlook for the remainder of the year which shows transition from the Exchequer Balance to the General Government Balance (using presentation in Table 1 and Table 2A of the EDP notification).	Monthly, 20 days after the end of each month
F.3	Quarterly data on main revenue and expenditure items of local Government.	Quarterly, 90 days after the end of each quarter
F.4	Quarterly data on the public service wage bill, number of employees and average wage (using the presentation of the Pay and Pension Bill with further details on pay and pension costs of local authorities).	Quarterly, 30 days after the end of each quarter
F.5	Quarterly data on general Government accounts, and general Government debt as per the relevant EU regulations on statistics.	Quarterly accrual data, 90 days after the end of each quarter
F.6	Updated annual plans of the general Government balance and its breakdown into revenue and expenditure components for the current year and the following four years, using presentation in the stability programme's standard table on general Government budgetary prospects.	30 days after EDP notifications
F.7	Data on short- and medium- /long-term debt falling due (all instruments) over the next 36 months (interest and amortisation) for Non-Commercial State Agencies	Quarterly, 30 working days after the end of each quarter
F.8	Data on short- and medium- /long-term debt falling due (all instruments) over the next 36 months (interest and amortisation) for local authorities	Quarterly, 30 working days after the end of each quarter
F.9	Data on short- and medium- /long-term debt falling due (all instruments) over the next 36 months for State- owned commercial enterprises (interest and amortisation)	Quarterly, 30 working days after the end of each quarter
F.10	Assessment report of the management of activation policies and on the outcome of job seekers' search activities and participation in labour market programmes.	Quarterly, 30 working days after the end of each quarter.
<b>To be provided by the NTMA</b>		
N.1	Monthly information on the central Government's cash position with indication of sources as well of number of days covered	Monthly, three working days after the end of each month
N.2	Data on below-the-line financing for central Government.	Monthly, no later than 15 working days after the end of each month

N.3	Data on the National Debt	Monthly, 15 working days after the end of each month
N.4	Data on short-, medium- and long-term debt falling due (all instruments) over the next 36 months (interest and amortisation) for the National Debt.	Monthly, 30 working days after the end of each month
N.5	Updated estimates of financial sources (bonds issuance, other financing sources) for the Exchequer Borrowing Requirement / National Debt in the next 12 months	Monthly, 30 working days after the end of each month
<b>To be provided by the Central Bank of Ireland</b>		
C.1	The Central Bank of Ireland's balance sheet.	Weekly, next working day
C.2	Individual maturity profiles (amortisation only) for each of the domestic banks will be provided as of the last Friday of each month.	Monthly, 30 working days after each month end.
C.3	Detailed financial and regulatory information (consolidated data) on domestic individual Irish banks and the banking sector in total especially regarding profitability (P&L), balance sheet, asset quality, regulatory capital; PLAR funding plan forecasts including LDR, NSFR and LCR outturns and forecasts.	Quarterly, 40 working days after the end of each quarter
C.4	Detailed information on deposits for the last Friday of each month.	Monthly, 30 working days after each month end.
C.5	Data on liabilities covered under the ELG Scheme for each of the Covered Institutions.	Monthly, 30 working days after each month end.
C.6	Deleveraging committee minutes from the banks and deleveraging sales progress sheets, detailing pricing, quantum, and other relevant result metrics.	Monthly, reflecting committee meetings held each month
C.7	Deleveraging reports including (i) progress achieved towards deleveraging in line with the 2011 Financial Measures Programme; and (ii) actual and planned asset disposals.	Quarterly, 40 working days after the end of the reference period.

## Ireland: Memorandum of Economic and Financial Policies

### A. Recent Economic Developments and Outlook

1. **Ireland's economic recovery slowed in the first half of 2012 and the outlook is for a modest pick-up in growth in 2013.** Real GDP growth fell to ½ percent y/y in the first half of 2012 as net exports weakened. Net exports remained the sole driver of economic growth, with domestic demand and employment continuing to fall, and unemployment has remained elevated at 14.8 percent. At the same time, lower net income outflows boosted GNP growth to 2¼ percent y/y and the current account surplus to 2.7 percent of GDP, although a reversal of some of these gains may be seen in the second half. HICP inflation rose to 2.0 percent y/y during the first three quarters of 2012 on the back of surging energy costs and administered price increases. Growth strengthening to over 1 percent is projected for 2013, but this pick up may be impeded by weaker growth expected in trading partners. In addition, further domestic demand contraction is expected as financial sector weaknesses, continuing uncertainties, together with the heavy debt burdens of households and SMEs, hinder lending, drive saving, and curb investment.

2. **Ireland has started to regain access to market funding in recent months, aided by policy developments at the European level.** Irish sovereign bond yields fell dramatically over the summer, benefitting from continued strong program implementation and the June 29 summit statement, providing an opportunity to re-enter the international bond market earlier and on more favourable terms than expected. Irish bond markets were boosted further by the ECB's OMT announcement in early September, with 8-year bond yields down to below 5 percent. We recognise that continued strong policy implementation is essential. In addition, with expectations of further European support priced in by the market, timely delivery on commitments to examine the situation of the Irish financial sector with the view of improving the sustainability of Ireland's adjustment program is necessary to maintain the positive momentum and facilitate our efforts to exit from reliance on official financing.

### B. Fiscal Policies

3. **We will meet the fiscal targets for 2012 and extend our track record of sound budgetary management.** The end-September targets on the exchequer primary balance and central government net debt were met with respective margins of 0.8 and 1.5 percentage points of GDP. Tax revenues are ahead of profile despite more challenging macroeconomic conditions, reflecting our prudent costing of measures and robust revenue collection efforts. Strong revenues, along with spending restraint in most areas, will compensate for overspending in health and social welfare, the latter on account of higher-than-expected unemployment. Overall, we are on track to deliver a general government deficit within the 8.6 percent of GDP target for 2012.

4. **We are alert to the overrun in current health spending, and are taking the measures necessary to unwind it.** We are committed to achieving health outcomes in an efficient manner and will contain health expenditure next year to within the €13.6 billion departmental ceiling for 2013 set in the *Comprehensive Expenditure Report 2012-14*, including by fully correcting the overrun from 2012. To this end, we have recently negotiated a significant multi-year reduction in the price of pharmaceuticals, and are seeking further durable savings, including through consideration of a range of structural reforms to:

- **Further reduce drug costs, including** by lowering the price of generic drugs and increasing the share of generics in prescriptions, dispensing and usage;
- **Enhance hospital efficiency**, by implementing major work practice and rostering reforms, reducing the average length of hospital stays, increasing the share of day treatments, and minimising unnecessary return visits for out-patients;
- **Improve the charging regime for private patients in public hospitals and increase collection of charges**, to fully account for costs; and
- **Better target spending**, particularly within the primary care re-imburement scheme.

5. **The recently-updated *Medium-Term Fiscal Statement (MTFS)* demonstrates our continued commitment to put the public finances on a sound footing.** As set out in the table below, we will be implementing consolidation measures of at least €8.6 billion over the next three years to bring the general government deficit below 3 percent of GDP by 2015, in line with the Stability and Growth Pact targets. We consider that this adjustment path strikes the right balance between debt sustainability and protecting growth and jobs.

**Fiscal Consolidation 2013–15, in € billion 1/**

	2013	2014	2015
<b>Total</b>	<b>3.5</b>	<b>3.1</b>	<b>2.0</b>
Expenditure	2.25	2.0	1.3
Current	1.70	1.9	1.3
Capital	0.55	0.1	0.0
Tax	1.25	1.1	0.7

1/ The amounts above *include* estimated tax carryovers of some €0.3 billion, €0.2 billion and €0.3 billion in 2013, 2014 and 2015, respectively; but *exclude* savings arising from measures to unwind the 2012 overrun in health spending and additional general government balance improvements as set out in the MTFS.

6. **We will submit Budget 2013 to the Oireachtas on December 5 to deliver these targets for 2013 (prior action).** In order to safely achieve the general government deficit below the program ceiling of 7.5 percent of GDP, the package will include: (i) primary current expenditure adjustments of €1.7 billion (excluding measures taken to unwind the 2012 health spending over-run); (ii) reductions in capital spending of €0.55 billion, consistent with the *Infrastructure and Capital Investment Plan 2012-16*; (iii) new tax measures of €1 billion; and (iv) additional general government balance improvements, including in respect of the local government sub-sector, as set out in the MTFS.

7. **Our budget will select a balance of expenditure and tax measures to achieve the consolidation in a durable, equitable and growth-friendly manner.**

**Current expenditure measures:**

- ***Accelerated reduction in the public sector wage bill:*** We will build on the recent overtime and sick pay reforms by targeting unjustified pay allowances for elimination, or medium-term restructuring. We are considering all options to improve the sustainability of the public sector wage bill, in order to achieve the envisaged current expenditure savings while protecting the delivery of public services.
- ***More targeted social supports and subsidies:*** We are reviewing a range of social transfers, including universal benefits, with a view to identifying savings while protecting the most vulnerable and minimising work disincentives. This review will take into account the Comprehensive Review of Expenditure and the projected increase in age-related spending, as highlighted in the recent actuarial review of the Social Insurance Fund. Student contributions to the cost of tertiary education are being raised, and a more stringent means-test for maintenance grants for undergraduates is being introduced.

**Tax measures:**

- ***Introduction of property tax:*** We are rolling out a recurrent tax on the value of private residences from July 1, 2013 to replace the household charge. The tax will be collected centrally by the Revenue Commissioners and will constitute an important and stable source of revenue.
- ***Tax base broadening:*** We are broadening the base for personal income taxes and pay related social insurance (PRSI) including by better targeting reliefs and tightening allowances.

- **Raising indirect tax revenues:** Following an intensive public consultation on environment-related taxation, we have decided to recalibrate the CO<sub>2</sub> band structure for vehicle registration and motor taxes. Options in relation to other indirect taxes, including excises, are also being considered.

8. **At the time of Budget 2013, we will specify as far as possible the tax and spending measures for the 2014–15 consolidation.** We are confident that the permanent consolidation measures outlined above will yield significant carry-over savings for 2014–15, reducing the residual consolidation to be identified. An early specification of this remaining consolidation will reduce uncertainties faced by households and businesses and thereby help support the revival of domestic demand.

9. **Having completed the core institutional fiscal reforms, we are looking to advance fiscal transparency.** The Fiscal Responsibility Bill will be signed into law on 27 November 2012, enshrining the independence of the Irish Fiscal Advisory Council, and establishing the fiscal rules for deficits and debt. We have published the legislation (amendment to the Ministers and Secretaries Act) to provide a statutory basis for the already operational multi-annual expenditure ceilings. We published an enhanced Exchequer statement at end-September 2012 and are seeking to further strengthen the reporting of general government accounts and fiscal risks (given the state's large asset and liability positions).

10. **We will continue to press forward with major public service reforms, which will further support budgetary sustainability into the medium term.** As the recent Progress Update on the November 2011 *Public Service Reform Plan* shows, major projects are being rolled out in the area of shared services, public procurement and the identification and evaluation of opportunities for external service delivery. In this overall context, the Public Service Agreement is operating as a key enabler of reform and productivity, helping to eliminate waste and to manage the ongoing reduction in public sector headcount while minimising the impact on service levels. We will step up our engagement with staff interests to ensure that all aspects of the Agreement are leveraged to enhance public sector efficiency to the fullest extent possible.

### C. Financial Sector Policies

11. **The key objective of our financial sector policy is to improve the health of the banking sector and thereby revive sound lending in support of the economic recovery.** While considerable progress has been made in recapitalising and deleveraging the PCAR banks, they continue to face significant asset quality, profitability, and liquidity challenges. Accordingly, we will gear our efforts towards ensuring the banks are: (i) managing their loan portfolios to arrest the deterioration of asset quality, (ii) improving their profitability through reductions in funding and operational costs, and (iii) advancing the restructuring of the banks. The effectiveness of these efforts would be greatly facilitated by the timely delivery of further European support along the lines indicated in the euro area summit statement of June 29, 2012.

12. **We are driving forward the effective implementation of the residential mortgage arrears resolution process.** We have made the resolution of mortgage arrears a top priority for banks, and are supervising their efforts to (i) set up and grow efficient loan collection operations; (ii) engage effectively with households in arrears; and, (iii) address unsustainable debt in a durable manner. Nonetheless, the rise in long dated arrears has continued. Banks have implemented pilots of mortgage resolution options and in some cases gone live with their strategies and we are taking the following steps to facilitate the stronger progress on implementation that is needed:

- **We will closely supervise banks' progress in achieving a durable reduction in mortgage arrears.** The MARS process will seek to ensure that: (i) borrowers in arrears are contacted in a timely fashion; (ii) subject to tight eligibility criteria, distressed debtors are offered sustainable loan modification options; and, (iii) other durable solutions are adopted where appropriate, including repossession proceedings, voluntary surrender, or mortgage to rent. We will monitor each bank's performance relative to already-defined key performance indicators for progress in resolving problem loans, and also against bank specific targets for reviewing new and existing individual arrears cases.
- **We will continue the implementation of the framework to monitor the effectiveness of the loan modification process.** We will publish banks' reported data on loan modifications, including re-

defaults of modified loans, to permit analysis of the effectiveness of alternative resolution approaches in improving debt service performance.

- **We will ensure appropriately prudent provisioning treatment of loan modifications.** We will continue to engage with banks and review the proposed provisioning treatment for all advanced loan modification products being introduced as part of their mortgage arrears resolution strategies. In addition, we will, in consultation with staff of the EC, ECB, and the IMF, update where necessary the 2011 Impairment Provisioning and Disclosure guidelines setting out the appropriate assumptions for all categories of advanced loan modifications.
- **To encourage and facilitate more active engagement with borrowers by banks, we will review the Code of Conduct for Mortgage Arrears.** In particular, we will conduct the review to commence in early 2013 to take account of developments in the arrears environment such as the forthcoming Personal Insolvency legislation and the longer term loan modifications that will be rolled out by the banks.
- Having secured adequate protections for debtors' principal private residence through the enactment of the Personal Insolvency Bill, we will by end March 2013 introduce legislation remedying the issues identified by case law in the 2009 Land and Conveyancing Law Reform Act, so as to remove unintended constraints on banks to realise the value of loan collateral under certain circumstances.
- **We will undertake a review of progress in addressing mortgage arrears by end-June 2013** (proposed structural benchmark).

13. **Establishing the new personal insolvency framework will support these efforts and help reduce household debt distress while maintaining debt service discipline.** The Personal Insolvency Bill has passed the committee stage in the Dáil and is expected to complete all Oireachtas stages by year-end. We will introduce further amendments ahead of its enactment including the licensing and regulation of personal insolvency practitioners. We are establishing the infrastructure to make the new insolvency framework operational by end January 2013 or very shortly thereafter. A newly appointed Director Designate of the Insolvency Service has been equipped with the resources to (i) develop the necessary IT infrastructure as early as possible in 2013, (ii) hire and train staff (iii) to publish, in particular in the context of the Debt Relief Notice process, and drawing on relevant research, guidelines for reasonable allowable household expenditures for debtors and (iv) conduct an information campaign for all likely to be concerned by the new insolvency processes. We have also completed the establishment of the Mortgage Advisory Service accessible through the internet where debtors can avail of a consultation with an independent financial advisor upon authorisation by their lender when offered advanced mortgage modification/long term forbearance under MARS.

14. **Resolving the balance sheet challenges of SMEs is critical to restoring their capacity to invest and create jobs.** We have recently launched the Temporary Partial Credit Guarantee scheme to facilitate lending to eligible SMEs. However, Irish SMEs with high indebtedness, often related to real estate investments, are often hampered in their ability to finance working capital and productive investments. Accordingly:

- **The CBI will monitor banks' implementation of arrears resolution strategies for SMEs.** The findings of the CBI review in this area were communicated to PCAR banks in August. Banks are strengthening their strategies and deploying adequate operational capacity to move away from short-term forbearance to more durable restructuring solutions.
- **We will improve the efficiency of the corporate insolvency framework for SMEs, drawing on the recommendations in the recent report by the Company Law Review Group.** In particular, by end-year we will prepare amendments to designate the Circuit Courts as competent for the examinership of companies within the EU small company thresholds (e.g., balance sheet below €4.4 million). Based on experience with the operation of the Insolvency Service in the personal insolvency reform, we will consider the appropriateness of further enhancements to the legal framework to reduce costs and achieve efficiency gains, including the potential for an administrative body to facilitate SME restructuring.

15. **We are redoubling our efforts to return PCAR banks to profitability, including by finalising a roadmap for the orderly withdrawal of the ELG Scheme.** We will continue to encourage further reductions of funding costs and urge continued operating cost savings in order to reduce their pre-provision operating losses. The strategy for weaning the banking system off the ELG Scheme while preserving financial stability, currently being developed by the inter-agency working group led by the Department of Finance, will be finalised by end-2012.

16. **We continue to advance bank restructuring.** PTSB has undertaken its initial internal reorganisation, including separation into three discrete business units with separate management accounts. We will monitor PTSB's performance against the benchmarks proposed for the three business units. AIB and PTSB have submitted restructuring plans to the competent EC authority, with a view to restoring core profitability.

17. **We are finalising the framework to restore the viability and solvency of the credit union sector.** Drawing on the recommendations in the Report of the Commission on Credit Unions issued in March, the Credit Union Bill 2012 was published on September 28. The Bill strengthens the regulatory framework of credit unions with a focus on four areas: prudential regulation, governance, restructuring and stabilisation. We are refining the Bill, including to clarify, that, to the extent any public resources provided for the purpose of restructuring of credit unions are not reimbursed by the restructured institution, they will be recouped in full by means of a levy on the credit union industry. The restructuring process will be led by a Restructuring Board (ReBo), which will be mandated to underpin the sustainability of the credit union sector in a planned and time-bound manner. The ReBo will work with credit unions to bring forward restructuring proposals, which will be subject to CBI regulatory approval. To facilitate this restructuring process, we will transfer €250 million to a Credit Union Fund by end 2012, and we request an adjustor to the performance criterion on the exchequer primary balance and the indicative target on the stock of central government net debt.

18. **We will provide by end 2012 a report reviewing developments relative to PCAR 2011.** The review will analyse indicators of banks' financial performance versus the PCAR base and stress case assumptions, and will assess the impact of the evolution of economic drivers. These indicators will include credit quality, loan loss provisions, losses from deleveraging, and pre-provision net revenue. The analysis will take into account significant deviations from PCAR 2011 assumptions, such as in liability management exercises. The report will also provide details of the evolution of risk weighted assets.

19. **We are continuing to strengthen financial supervision and regulation. Key deliverables will be as follows:**

- ***Supervision and Enforcement Legislation:*** Efforts to finalise the Central Bank (Supervision and Enforcement) Bill are on-going and the committee stage amendments are expected to be finalised shortly. We recognise the criticality of this legislation, especially with regard to strengthening the CBI's investigation, direction and enforcement powers, and are determined to move the Bill forward expeditiously.
- ***Banking supervision and securities regulation:*** The CBI has begun an internal self-assessment of Ireland's observance of the recently revised *Basel Core Principles (BCP) for Effective Banking Supervision*. We will request an external BCP assessment by end March (proposed structural benchmark), with the aim to be completed by end-December 2013. We will also complete an International Organisation of Securities Commissions, (IOSCO) Objectives and Principles of Securities Regulation self-assessment, and will request an external assessment with the aim to be completed by end-December 2013.
- ***Resolution fund levy:*** In September, we issued regulations for a levy on credit institutions designed to accumulate funding over the medium to long term to build a fund for resolution actions of €100m. We intend to recoup the public resources provided to the Resolution Fund mainly for the resolution of credit unions. Upon publication of the EU directive establishing a framework for the recovery and resolution of credit institutions and investment firms, we will review this regulation.
- ***Risk weighted assets:*** The CBI is well advanced in enhancing its approach to Credit Risk, risk weighted asset (RWA) supervision including conducting annual model performance reviews, assessing RWA calculation and reviewing banks' approaches to RWA forecasting and stress testing in



advance of PCAR 2013. The next steps will include completing the reviews and issuing mitigating actions for the banks concerned by end 2012.

20. **We will put in place an effective credit register to facilitate sound lending decisions and to aid financial supervision.** Issues of data protection have delayed finalisation of the Credit Reporting Bill 2012 that was published last September. Following the publication of the Bill at end-September 2012, a consultation process has commenced to consider potential Committee Stage amendments. Following the completion of the parliamentary process, the Central Bank, as the owner, will undertake a procurement exercise, with the goal of having the Register operational by end 2013.

#### D. Structural Reforms

21. **Enhancing growth and job creation remains our top priority.** Commencing in 2013, we are supplementing our exchequer capital expenditure programme by €1.4 billion through public-private partnerships with the European Investment Bank, the National Pension Reserve Fund, and private investors. Projects have been identified in education, transport, health care, and justice. We are also proceeding with the disposal of state assets in the energy generation and forestry sectors in 2013 as planned, while the sale of a minority stake in Aer Lingus hinges on market conditions and antitrust concerns. We will use at least half of the proceeds from these asset disposals to reduce public debt in due course, with the details on timing and implementation to be agreed. Once realised, the remaining proceeds will be reinvested in job-rich projects of a commercial nature, consistent with our fiscal targets.

22. **We are continuing to implement the Action Plan for Jobs, which aims to support employment creation through wide-ranging set of measures.** We have implemented almost 90 percent of the planned measures by end September, including: establishing new Technology Centres in Cloud Computing, Learning Technologies and Financial Services; launching of the Microfinance Fund that will provide small loans to businesses with up to 10 employees; and initiating an intra-agency partnership *Smart Futures* for promoting careers in science. To bring down the cost of doing business, we have reduced stamp duty and have introduced capital gains tax incentives for certain types of properties. We will continue to identify and implement measures to improve the business climate in 2013 and beyond, with a focus on promoting access to finance and investment by SMEs, supporting indigenous start-ups and assisting indigenous business to grow, and developing and deepening the impact of foreign direct investment.

23. **We are stepping up our reforms of activation, training, and social welfare payments to help reduce unemployment over time:**

- ***Pathways to Work.*** We have launched the new one-stop shop unemployment support service—Intreo—in four locations, and expect to have ten offices operational by end-2012. By combining the previously separate services of the Department of Social Protection, FAS, and the Community Welfare Service, Intreo will provide a more coherent and tailored package of employment services. Under the new system, engagement with job seekers will take place on a contractual basis with welfare payments contingent on participation in activation programs and job search efforts, where a lack of engagement would result in sanctions. We will triple the number of ‘live’ offices to 30 by the end of 2013, with a further 30 coming on stream before the end of 2014. This roll out will accelerate profiling of job seekers and further increase engagement at both the group and the individual level.
- ***Engagement with long term unemployed.*** We are taking steps to increase engagement with long term unemployed people through their inclusion in the Intreo activation process through greater use of the Local Employment Services Network, more targeted use of Community Employment and other work placement schemes, appropriate training schemes and through increased promotion of employer incentives encouraging the recruitment of long term unemployed people. It is anticipated that these steps, together with external contracting (see next bullet point) will enable the delivery of the targets with respect to long term unemployment set out in the Pathways to Work policy document.
- ***Involving the private sector in employment services provision, especially for the long-term unemployed.*** We have established a cross-departmental working group to oversee the process of engaging private employment services firms, which will expand resources to service the needs of job seekers, helping address the current shortfall in qualified case workers. By end-February 2013 we will prepare draft remuneration contracts for the private firms that are in line with international best

practice with support from external experts. We plan to issue a tender for the provision of services by end March 2013, and these new services are expected to be operational by end-2013.

- **Reforming the further education system, including for the unemployed.** In order to strengthen training provision, we have recently published legislation to establish 16 Education and Training Boards, replacing the existing 33 Vocational Education Committees. The action plan for establishing SOLAS—an institution to coordinate and fund training and further education programs—will be completed by end-November, and by the end-December we will publish legislation to launch SOLAS. We have completed a financial review of the Community Employment programme, and by end-January 2013 we will prepare a comprehensive review of activation programs, which will guide us in further reforming the activation and training services provided to the unemployed.
- **Housing assistance.** We intend to replace the current rent supplement for individuals with a long-term housing need with a new Housing Assistance Payment (HAP). Operated by the relevant housing authority, HAP will allow rent supplement to address its original objective as a short-term income support measure and will provide for the creation of an integrated social housing market. One of the benefits of HAP will be that it will be based on a differential rent, therefore enabling employment take-up by tenants who may previously have been caught in a poverty trap if they entered the workforce. Before HAP can be implemented, it will be necessary to introduce a system of non-discretionary deduction of rent. It is intended that this issue will be addressed via legislative amendments in the Social Welfare Budget Bill, 2012 (by end December 2012) to amend the Household Budgeting Scheme and the Social Welfare & Pensions Bill, 2013 in Spring 2013 (by end June 2013) to facilitate non-discretionary deduction on a wider level. It will also be necessary to enact the Housing (Miscellaneous Provisions) Bill, 2012 (summer 2013). It is the intention that HAP will be piloted in the second half of 2013 and made fully operational in 2014 with general roll out and commencement of transfers from early January 2014.

#### **E. Programme Financing and Monitoring**

24. **Our financing strategy aims to ensure the program is adequately financed and to help develop the basis for moving towards relying on market access.** Following our return to Treasury bond and bill issuances in July, we have instituted monthly Treasury bill auctions, with yields now below 1 percent, and we have also raised €1 billion in long-term funding with an initial issue of amortising bonds targeted at domestic pension funds. Building on this progress, we will seek to further broaden our investor base and increasingly move to regular bond issuances, which will account for a rising share of our financing. We will also continue to tap other sources such as amortising bonds when market conditions are favourable. In view of the external risks to our financing, we will continue to maintain a prudent cash buffer and aim to end the programme with a buffer covering around one year of financing needs to support market confidence.

25. **Implementation of the policies under the programme will continue to be monitored through quarterly and continuous performance criteria, indicative targets, structural benchmarks, and quarterly programme reviews, as envisaged in our Letters of Intent since the inception of the arrangement on 3 December 2010 along with this letter.** The programme also continues to be in compliance with requirements under the Memorandum of Understanding on Specific Policy Conditionality. The attached Technical Memorandum of Understanding (TMU) defines the quantitative performance criteria and indicative targets under the programme. The Government's targets for the exchequer primary balance are monitored through quarterly performance criteria and net central government debt is an indicative target (Table 2). As is standard in EU/IMF arrangements, there is a continuous performance criterion on the non-accumulation of external payment arrears. Progress on implementing structural reforms is monitored through structural benchmarks (Tables 1 and 3).

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

**Table 1. Programme Monitoring**

<b>Measure</b>	<b>Date</b>	<b>Status</b>
<b>Quantitative Performance Criteria</b>		
Cumulative exchequer primary balance	End-September 2012	Observed
<b>Indicative Target</b>		
Ceiling on the stock of central government net debt	End-September 2012	Observed
<b>Continuous Performance Criteria</b>		
Ceiling on the accumulation of new external payments arrears on external debt contracted or guaranteed by the central government	Continuous	Observed
<b>Structural Benchmarks</b>		
Define the criteria to run stringent stress tests scenarios.	End-December 2010	Observed
Agree on terms of reference for the due diligence of bank assets by internationally recognised consulting firms.	End-December 2010	Observed
The Central Bank will direct the recapitalisation of the principal banks (AIB, Bol and EBS) to achieve a capital ratio of 12 percent core tier 1.	End-February 2011	Not observed <sup>1/</sup>
Submit to Dáil Éireann the draft legislation on a special resolution regime.	End-February 2011	Observed <sup>2/</sup>
The Central Bank to complete the assessment of the banks' restructuring plans.	End-March 2011	Observed
Complete the diagnostic evaluation of banks' assets.	End-March 2011	Observed
Complete stress tests (PCAR 2011).	End-March 2011	Observed
Complete a full assessment of credit unions' loan portfolios	End-April 2011	Observed
Finalise plans for the recapitalisation of Irish Life and Permanent.	End-May 2011	Observed
Establish a Fiscal Advisory Council.	End-June 2011	Observed
Complete the recapitalisation of Allied Irish Banks, Bank of Ireland, Irish Life and Permanent and EBS Building Society.	End-July 2011	Observed
Submit the Supervision and Enforcement Bill to Oireachtas.	End-July 2011	Observed
Complete the legal merger procedures of Allied Irish Bank and EBS Building Society.	End-September 2011	Observed
Publish a memorandum of understanding governing the relationship of the Department of Finance and the Central Bank in relation to banking sector oversight.	End-October 2011	Observed <sup>3/</sup>
The merger of Irish Nationwide Building Society and Anglo-Irish bank.	End-December 2011	Observed
Central Bank to issue guidance to banks for the recognition of accounting losses incurred in their loan book.	End-December 2011	Observed
Finalise a strategy to guide the development of broader legal reforms around personal insolvency, including significant amendments to the Bankruptcy Act 1998 and the creation of a new structured non-judicial debt settlement and enforcement system.	End-December 2011	Observed

Introduce a medium-term expenditure framework with binding multi-annual expenditure ceilings with broad coverage and consistent with the fiscal consolidation targets.	2012 Budget day in early December 2011	Observed
Updated restructuring plan for the PTSB detailing the actions needed to ensure viability of its core businesses.	End-June 2012	Observed
Submit to parliament, as part of the Fiscal Responsibility Bill, a legal framework for the Fiscal Advisory Council ensuring its independence.	End-September 2012	Observed
Publish legislation to strengthen the regulatory framework for credit unions, including making legislative provision for effective governance standards and prudential requirements	End-September 2012	Observed
Approve regulations to establish a charge levied across credit institutions to recoup over time the costs of resolving vulnerable institutions	End-September 2012	Observed

1/ Central Bank directions were issued within the required timeframe. However, completion of the capital injections required was postponed by the Minister for Finance until after the General Election. These directions are now superseded by the Central Bank's PCAR directions of 31 March 2011.

2/ In practice this was submitted to the Seanad as discussed in paragraph 21 of the MEFP, as the Dáil was dissolved owing to the elections.

3/ Effective end-October 2011 and posted on November 8, 2011.

Table 2. Ireland: Quantitative Performance Criteria and Indicative Targets  
Under the Economic Programme for 2011–13

	31-Dec-11		31-Mar-12		30-Jun-12		30-Sep-12		31-Dec-12	31-Mar-13	30-Jun-13	30-Sep-13
	Target 1/ Outcome	Outcome	Target 1/ Outcome	Outcome	Target 1/ Outcome	Outcome	Target1/ Outcome	Outcome	Target	Target	Target	Target
(In billions of Euros)												
	Performance Criterion		Performance Criterion		Performance Criterion		Performance Criterion		Performance Criterion	Performance Criterion	Indicative Target 4/	Indicative Target 4/
1. Cumulative exchequer primary balance 2/	-22.3	-21.0	-6.9	-5.7	-9.6	-8.7	-11.4	-10.1	-11.2	-3.7	-4.3	-4.9
2. Ceiling on the accumulation of new external payments arrears on external debt contracted or guaranteed by the central government 3/	0	0	0	0	0	0	0	0	0	0	0	0
	Indicative Target		Indicative Target		Indicative Target		Indicative Target		Indicative Target	Indicative Target	Indicative Target	Indicative Target
3. Ceiling on the stock of central government net debt 1/	117.2	115.7	125.0	123.0	130.1	128.2	132.5	130.0	135.5	143.1	149.2	150.4

1/ Adjusted.

2/ Measured by the exchequer balance excluding interest payments. Cumulative from the start of the relevant calendar year.

3/ Applies on a continuous basis.

4/ Exchequer primary balance targets after 31-December 2012 exclude payments in respect of the IBRC Promissory Note that have thus far – for program purposes – been considered part of exchequer non-voted capital spending.

Table 3. Ireland: Upcoming Prior Action and Structural Benchmarks under the Programme for 2013

Measure	Date	Status
<b>Financial sector policies</b>		
Request an external BCP assessment in support of efforts to strengthen financial supervision and regulation (MEFP ¶19).	End-March 2013	Proposed structural benchmark
Undertake a review of progress in addressing mortgage arrears (MEFP ¶12).	End-June 2013	Proposed structural benchmark
<b>Fiscal policies</b>		
Submit Budget 2013 to the Oireachtas (MEFP ¶6).	5 December 2012	Prior action

## Technical Memorandum of Understanding (TMU)

November 29, 2012

1. This Technical Memorandum of Understanding (TMU) sets out the understandings regarding the definitions of the indicators subject to performance criteria and indicative targets under the arrangement supported by the Extended Fund Facility (EFF). These performance criteria and indicative targets are reported in Table 2 attached to the Memorandum of Economic and Financial Policies (MEFP). This TMU also describes the methods to be used in assessing the programme performance and the information requirements to ensure adequate monitoring of the targets.

2. For programme purposes, all foreign currency-related assets, liabilities, and flows will be evaluated at “programme exchange rates”, with the exception of the items affecting the government fiscal balances, which will be measured at current exchange rates. The programme exchange rates are those that prevailed on December 30, 2011 as shown on the IMF’s website ([http://www.imf.org/external/np/fin/data/rms\\_five.aspx](http://www.imf.org/external/np/fin/data/rms_five.aspx), accessed 19 January 2012), in particular, €1 = 1.2939 U.S. dollar and €1 = 0.842786 SDR.

### I. QUANTITATIVE PERFORMANCE CRITERIA AND INDICATIVE TARGETS

#### Floor on the Exchequer Primary Balance

3. The Exchequer balance is the traditional domestic budgetary aggregate which measures the net surplus or net deficit position of the Exchequer Account. The Exchequer Account is the single bank account of the Central Fund and is held at the Central Bank of Ireland. The annual audited accounts of the Exchequer Account produced by the Department of Finance are known as the Finance Accounts. An unaudited summary known as the Exchequer Statement is produced at the end of each month. Under the Irish Constitution, all Government receipts are paid in to the Central Fund and all Government expenditure is funded from it, unless provided otherwise by law.<sup>1</sup> The Exchequer balance is the difference between total receipts into, and total expenditure out of, the Exchequer Account. It measures the sum of the current and capital balances. The current balance is defined as current receipts (tax and non-tax revenue) minus current expenditure (voted expenditure and non-voted expenditure charged directly on the Central Fund, including the Sinking Fund). The capital balance is defined as capital receipts (Sinking Fund and other capital receipts) minus capital expenditure (voted and non-voted expenditure). The Sinking Fund provision is a transfer from the current account to the capital account to reduce national debt and has no effect on the overall Exchequer balance.

4. The performance criteria are set on the Exchequer primary balance which is the Exchequer balance excluding net debt interest payments in the service of the National Debt. From January 2013 all payments

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<sup>1</sup> Receipts of the Central Fund comprise Exchequer tax revenues, non-tax revenues, receipts from the European Union and other capital receipts. Charges on the Central Fund include the expenditure of Government departments and offices, payments related to the servicing of the national debt, payments to the European Union Budget, the salaries, pensions and allowances of the President, judiciary, and Comptroller & Auditor General and the running costs of the Houses of the Oireachtas (Parliament). Extra-budgetary funds (including the National Pensions Reserve Fund), the Social Insurance Fund, semi-state bodies and local governments are not part of the Exchequer system.

related to the IBRC promissory notes are excluded from the Exchequer primary balance measure used for programme monitoring purposes.<sup>2</sup>

5. For the purposes of the programme, the floor on the Exchequer primary balance (quantitative performance criterion) will be adjusted

- (i) downward by payments for bank restructuring carried out under the programme's banking sector support and restructuring strategy. Such payments may include, inter alia, loans to banks, investments in their equity (requited recapitalisation), unrequited recapitalisation, and purchases of troubled assets, which are carried out in line with programme objectives,
- (ii) upward by the amount of proceeds from sales of bank equity held by the government or NPRF that are treated as Exchequer receipts,
- (iii) upward by the amount of receipts from disposals of state assets specified in the paragraph 21 of the MAFP dated [xx November 2012],
- (iv) downward by the amount of these receipts spent on growth-enhancing projects not included in Budget 2013, up to no more than half of these receipts,
- (v) downward for Exchequer contributions to the Resolution Fund for the resolution of credit institutions, and upward for any Exchequer recoupment from the Resolution Fund, of such outlays.
- (vi) downward for Exchequer contributions to the Credit Union Fund for the restructuring of credit unions up to €250 million cumulatively, and upward for any Exchequer recoupment, from the Credit Union Fund, of such outlays.

Any other financial operation by Government to support banks or other credit institutions including credit unions, including the issuance of guarantees or provision of liquidity, will be reported to EC, IMF, and ECB staffs.

6. The floor on the Exchequer primary balance (quantitative performance criterion) in each year will be measured cumulatively from the start of that calendar year.

Cumulative Exchequer primary balance	(In billions of Euros)
From January 1, 2012:	
End-December 2012 (performance criterion)	-11.2
End-March 2013 (performance criterion)	-3.7
From January 1, 2013	
End-June 2013 (indicative target)	-4.3
End-September 2013 (indicative target)	-4.9

<sup>2</sup> Net debt interest payments are as per the end-month Exchequer Statements.



7. The performance criterion on the Exchequer primary balance (floor) will be adjusted upward (downward) for the full amount of any over-performance (under-performance) in Exchequer tax revenues, pay-related social insurance contributions (PRSI) and national training fund contributions against the current projection which is listed below:<sup>3</sup>

Cumulative Exchequer tax revenue & other receipts (as outlined in 7. above)	(In billions of Euros)
From January 1, 2012:	
End-December 2012 (projection)	44.1
From January 1, 2013	
End-March 2013 (projection)	10.2
End-June 2013 (projection)	20.9
End-September 2013 (projection)	32.2

8. Any policy changes, including in administration and enforcement of taxes, which impact the revenue projection set out in paragraph 7 will lead to a reassessment of the adjustor in the context of program reviews.

## Ceiling on the Stock of Central Government Net Debt

9. The stock of net central government debt, for the purposes of the programme, is defined as the National Debt less liquid assets of the National Pensions Reserve Fund (NPRF). The National Debt is defined as the total outstanding amount of principal borrowed by central government and not repaid as of the test date, less liquid assets available for redemption of those liabilities at the same date. These liquid assets comprise the Exchequer cash balances (including cash in the Capital Services Redemption Account), Exchequer deposits with commercial banks and other institutions, and investments in investment grade sovereign bills. For the purposes of the programme, NPRF liquid assets include the asset classes listed above, and also all marketable securities such as equities, government bonds and other listed investments. NPRF shares in domestic Irish banks, as well as the NPRF's non-liquid discretionary portfolio are excluded from the definition of liquid assets.

10. For the purposes of the programme, the ceiling on the central government net debt (indicative target) will be adjusted<sup>4</sup>

- (i) upward by debt arising from payments for bank restructuring carried out under the programme's banking sector support and restructuring strategy. These payments may include, inter alia, loans to banks, investments in their equity (required recapitalisation);

<sup>3</sup> As of November 2012, Exchequer tax receipts are comprised of income tax (including the universal social charge), value added tax (VAT), corporation tax, excise duties, stamp duties, capital gains tax, capital acquisitions, tax and customs duties and property tax (as from 2013).

<sup>4</sup> Although all payments related to the IBRC promissory notes are excluded from the Exchequer primary balance measure used for programme monitoring purposes, they are included in the Central Government net debt measure used for programme monitoring purposes.

unrequited recapitalisation; and purchases of troubled assets, which are carried out in line with programme objectives,

- (ii) downward by the amount of proceeds from sales of bank equity held by the government or NPRF that are treated as Exchequer or NPRF receipts,
- (iii) downward by the amount of receipts from disposals of state assets specified in the paragraph 21 of the MEFP dated [xx November 2012],
- (iv) upward by the amount of these receipts spent on growth-enhancing projects not included in Budget 2013, up to no more than half of these receipts,
- (v) upward for Exchequer contributions to the Resolution Fund for the resolution of credit institutions, and downward for any Exchequer recoupment, from the Resolution Fund, of such outlays.
- (vi) upward for Exchequer contributions to the Credit Union Fund for the restructuring of credit unions up to €250 million cumulatively, and downward for any Exchequer recoupment, from the Credit Union Fund, of such outlays.
- (vii) downward by the amount liquidated from the NPRF non-liquid discretionary portfolio,
- (viii) downward (upward) by valuation gains (losses) in the NPRF liquid portfolio. The programme exchange rates will apply to all non-Euro denominated debt.

11. The ceiling on the outstanding stock of central government net debt will be adjusted upward (downward) by the amount of any final upward (downward) revision to the stock of end-June 2012 central government net debt.

Central government net debt	(In billions of Euros)
Outstanding stock:	
End-September 2012 (provisional)	130.0
End-December 2012 (indicative target)	135.5
End-March 2013 (indicative target)	143.1
End-June 2013 (indicative target)	149.2
End-September 2013 (indicative target)	150.4

## **Non-accumulation of External Payments Arrears by Central Government**

12. The central government will accumulate no external payments arrears during the programme period. For the purposes of this performance criterion, an external payment arrear will be defined as a

payment by the central government on its contracted or guaranteed external debt that has not been made within five business days after falling due, excluding any contractual grace period. The performance criterion will apply on a continuous basis.

13. The stock of external payments arrears of the central government will be calculated based on the schedule of external payments obligations reported by the National Treasury Management Agency.

## **II. REPORTING REQUIREMENTS**

14. Performance under the programme will be monitored using data supplied to the EC, IMF, and ECB staffs. The Irish authorities will transmit promptly any data revisions.

- The Department of Finance will report to the EC, IMF and ECB staff, with a lag of no more than seven days after the test date the following data: the Exchequer primary balance, Exchequer tax revenues, payments for bank restructuring carried out under the programme's banking sector support and restructuring strategy, proceeds from sales of bank equity held by the government or NPRF that are treated as Exchequer receipts, receipts from disposals of state assets specified in the paragraph 21 of the MAFP dated [xx November 2012] and associated outlays on growth-enhancing projects not included in Budget 2013, Exchequer outlays for the resolution and restructuring of credit unions, any return of such outlays to the Exchequer and also for the recoupment of such outlays by the Exchequer from the Resolution Fund and the Restructuring and Stabilisation Fund.
- The National Treasury Management Agency will provide provisional figures on the outstanding stock of net government debt, including an unaudited analysis of NPRF holdings, with a lag of no more than seven days after the test date. The revised figures will be provided within three months of the test date.
- The National Treasury Management Agency will provide the final stock of the central government system external payments arrears to the EC, IMF and ECB staff, with a lag of not more than seven days after the arrears arise in accordance with the definition of external payments arrears as set forth in paragraph 12 of this memorandum.
- The Central Bank of Ireland will provide on a quarterly basis, bank by bank data on the assets of government guaranteed banks, including loans and provisioning by period overdue (90+days and less than 90 days) and category of borrower, 40 working days after the end of each quarter.