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Ireland: 2002 Article IV Consultation—Staff Report and Public Information Notice on the Executive Board Discussion

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2002 Article IV consultation with Ireland, the following documents have been released and are included in this package:

- the staff report for the 2002 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **May 16, 2002,** with the officials of Ireland on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on July 9, 2002.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its July 31, 2002 discussion** of the staff report that concluded the Article IV consultation.

The document(s) listed below have been or will be separately released.

Selected Issues Paper

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to Publicationpolicy@imf.org.

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IRELAND

Staff Report for the 2002 Article IV Consultation

Prepared by the Staff Representatives for the 2002 Consultation

Approved by Ajai Chopra and Martin Fetherston

July 9, 2002

- The Article IV consultation discussions were held in Dublin during May 7–16, 2002. The mission comprised Ms. Coorey (head), Ms. Cerra, Messrs. Lutz and Soikkeli (all EU1). The mission met with the Secretary General of the Department of Finance, the Governor of the Central Bank, the Auditor General, other senior officials, the employers' federation, trade unions, and members of the financial and academic communities. Mr. Bennet (Executive Director) and Mr. O'Murchú (Alternate Executive Director) attended some of the meetings.

- Ireland has accepted the obligations of Article VIII, Sections 2, 3, and 4, and maintains an exchange system free of restrictions, other than those in accordance with U.N. Security Council resolutions and EU regulations (Appendix I).

- Ireland has subscribed to the Special Data Dissemination Standard (SDDS).

- The authorities intend to publish the staff report.

- A coalition government headed by Prime Minister Bertie Ahern was returned to power following the May elections.

- At the conclusion of the last consultation in August 2001, Directors commended the authorities for Ireland's outstanding economic performance. They noted, at the same time, that the fiscal stance should have been neutral, rather than expansionary, in 2001. Directors suggested that the centralized wage bargaining process be reformed to allow private sector wages to be fully market determined and to align public and private pay for comparable jobs.

Contents Page

I. Overview and Key Issues 3

II. Report on the Discussions 9
A. Why Did Ireland Weather the Global Slowdown Relatively Well? 9
B. The Celtic Tiger Tamed? 12
C. Fiscal Policy: Adjusting to Slower Growth 15
D. Wage Policy: Maintaining Flexibility and Preventing Instability 21
E. Are There Major Housing Market or Financial Sector Risks? 22
F. Structural Policies: Improving Competition to Increase Service Sector Productivity 23
G. Other Issues 24

III. Staff Appraisal 24

Figures
1. Output Growth and Labor Market Trends 4
2. Fiscal Trends 5
3. Comparisons of Key Indicators with Other Euro Area Countries, 2001 6
4. Asset and Consumer Prices 7
5. High Frequency Indicators 8
6. Nominal and Real Exchange Rates 10
7. Money, Credit, and Interest Rates 11
8. GDP and the Output Gap 13

Tables
1. Selected Economic Indicators 28
2. Contribution to GDP Growth 29
3. Summary of Balance of Payments 30
4. General Government Finances 31
5. Medium-Term Fiscal Outlook 32
6. Indicators of External and Financial Vulnerability 33

Appendices
I. Fund Relations 34
II. Statistical Issues 35

I. Overview and Key Issues

1. **Ireland has sustained an impressive economic boom in the last decade reflecting good policies and, to some extent, good luck.** Real GDP growth averaged above 7 percent in 1991–2001 reflecting a confluence of factors (Figure 1): favorable demographics—a young, educated population and rising female labor force participation; a robust external environment, particularly relating to the U.S. and U.K. markets; EU and EMU membership; a policy environment—especially low corporate tax rates—conducive to foreign investment; substantial fiscal consolidation; and national wage agreements that contributed to wage moderation and social consensus. High growth and prudent public spending provided scope for both cutting taxes and rapidly reducing the public debt ratio to 36½ percent of GDP by end-2001 (Figure 2). Unemployment fell dramatically and, as the economy approached full-employment, per-capita income rose above the EU average.

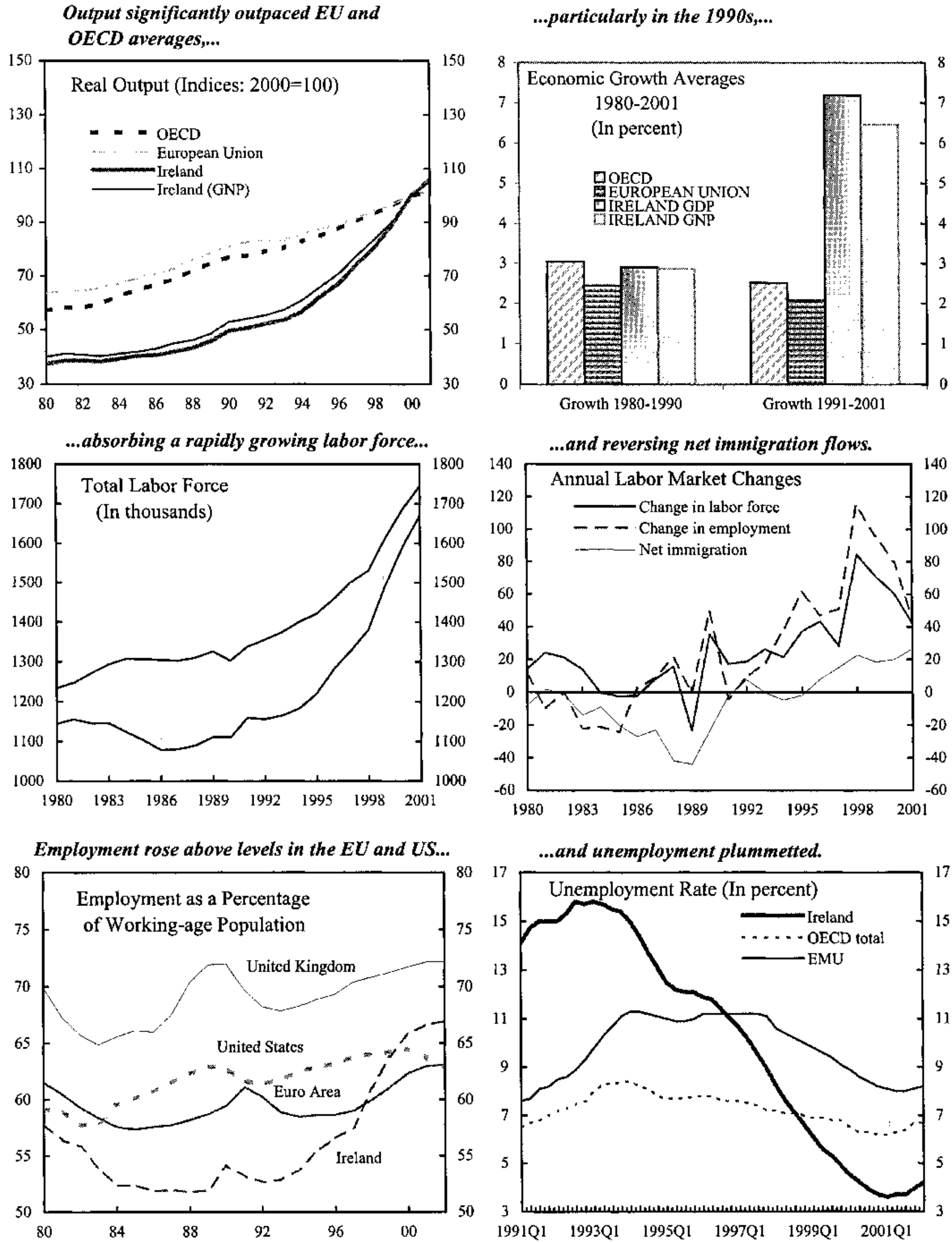
2. **Ireland's economy weathered the recent global slowdown better than might have been expected given its openness and concentration of ICT investment** (Figure 3). GDP growth slowed to 6 percent in 2001 from 11½ percent the previous year as output fell sharply mid-year (Table 1). However, unemployment effects were marginal, with the claimant count basis rate edging up to 4.2 percent by May 2002. Inflation abated and the harmonized measure dipped to 3½ percent (year-on-year) in November, before spiking up again in early 2002 mainly due to indirect tax increases. The asset price boom was interrupted, with house prices falling for five consecutive months during September-January. In May 2002, house prices registered an year-on-year increase of only 5 percent , compared with 17percent a year earlier (Figure 4).

3. **The economic slowdown exposed a dramatic weakening of the public finances, which—given past consolidation—nonetheless remain strong.** In contrast to previous years, the fiscal outturn was significantly lower than budgeted in 2001, partly due to weaker revenues, and the path for medium-term structural balances in the 2002 Stability Programme was shifted down sharply.

4. **Recent indicators suggest that growth has begun to recover, but medium-term prospects, although highly uncertain, are likely to be considerably subdued relative to the late 1990s.** After a sharp decline in the third quarter of 2001, growth resumed in the fourth quarter and there are signs—as yet uneven—of a recovery, including rising manufacturing output, retail sales (excluding automobiles), house prices as well as consumer and business confidence (Figure 5). Nevertheless, output growth is likely to trend down over the medium term as labor force growth slows reflecting demographics and already low unemployment; and foreign direct investment (FDI) returns to more normal levels after the bursting of the ICT bubble.

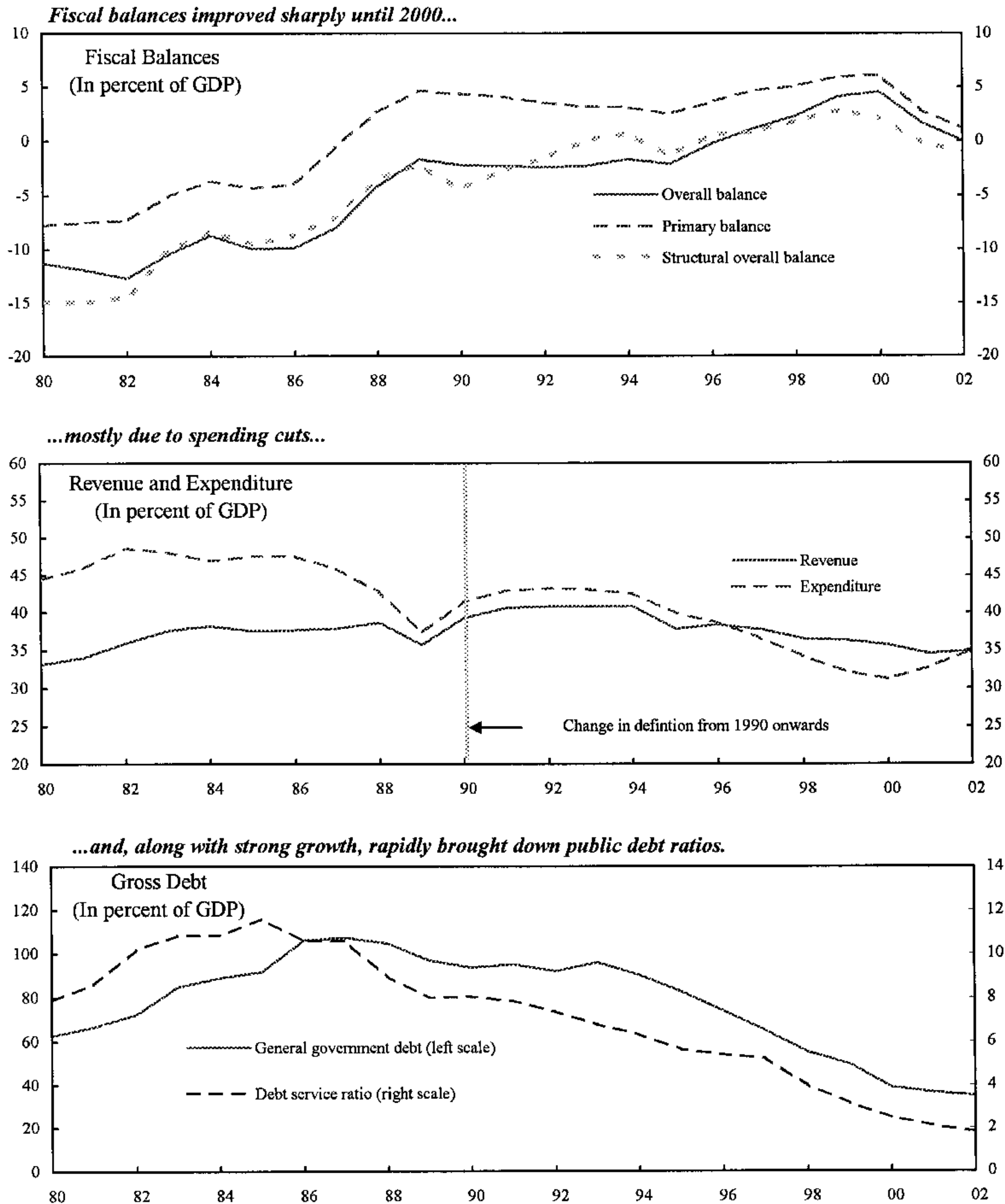
5. **Against this background, the discussions focused on a potentially changed economic and policy environment, addressing the following key issues:** (1) Why did Ireland weather the global slowdown and ICT bust relatively well? (2) Are there risks ahead to its superior economic performance? (3) How should fiscal and wage policies respond to

Figure 1. Ireland: Output Growth and Labor Market Trends



Sources: Central Statistics Office; OECD Main Economic Indicators; WEO; and IMF staff estimates.

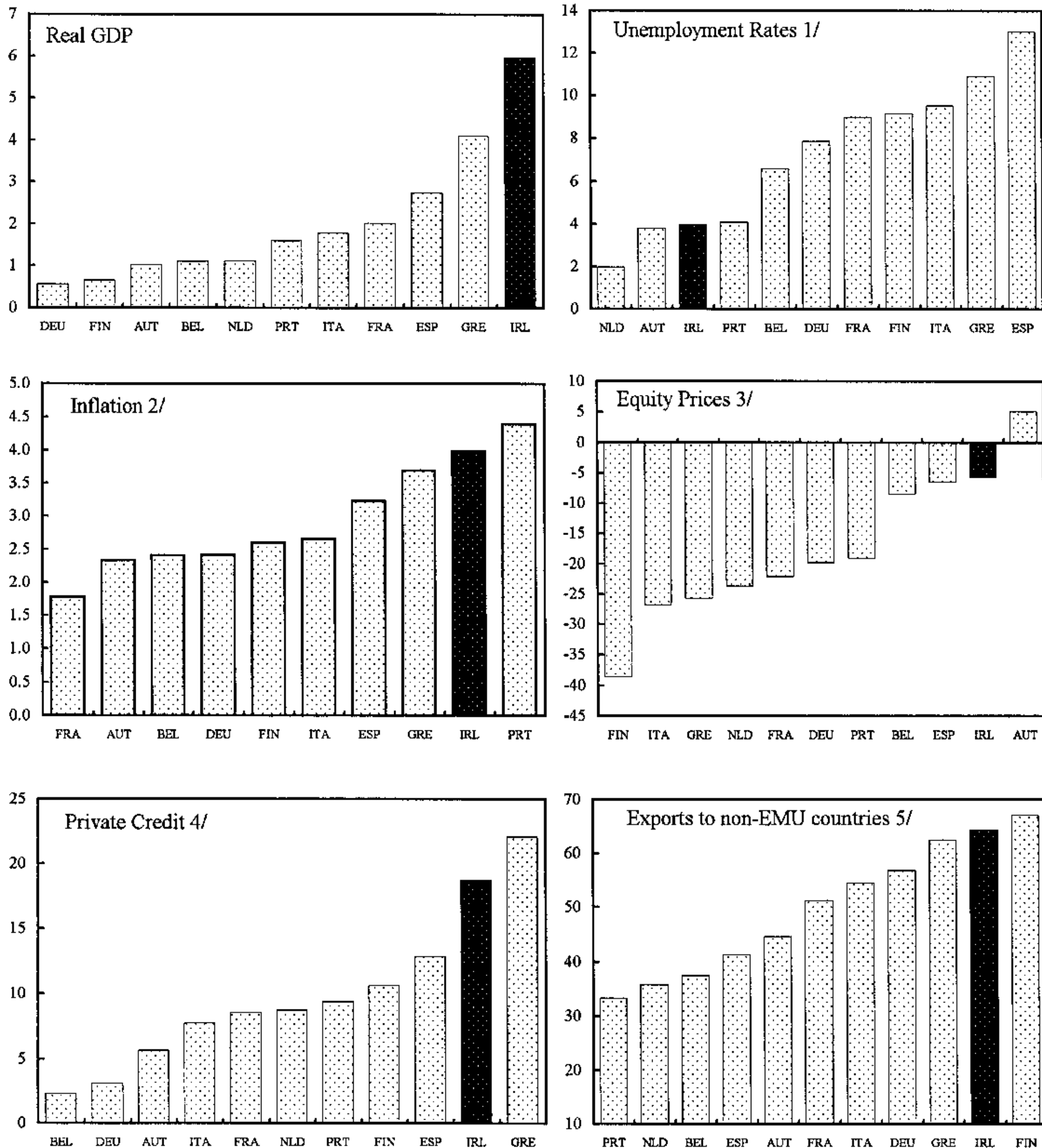
Figure 2. Ireland: Fiscal Trends



Sources: Department of Finance; and Central Bank of Ireland

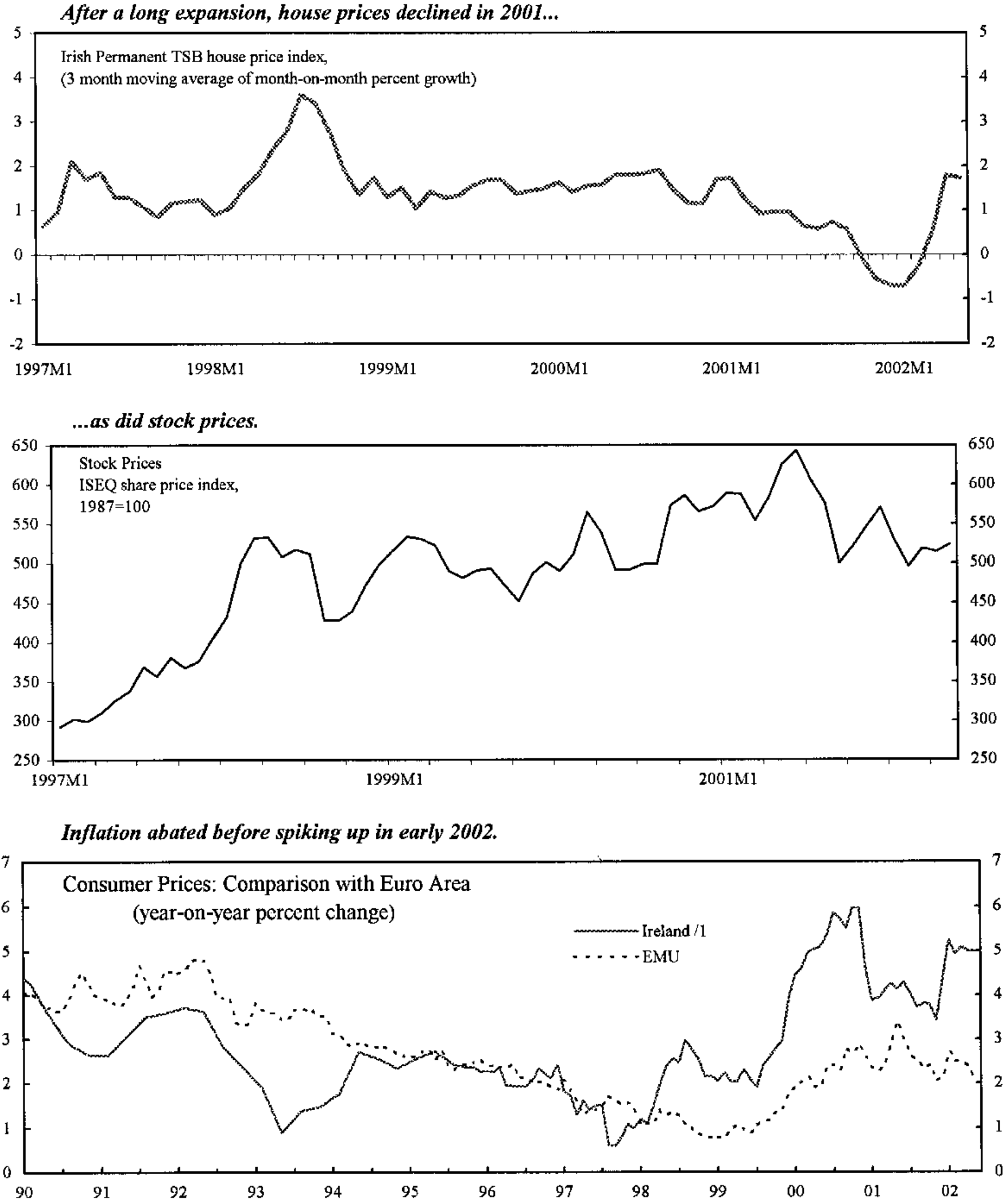
Figure 3. Ireland: Comparisons of Key Indicators with Other Euro Area Countries, 2001.
(Annual percent change, unless otherwise indicated)

Ireland weathered the global slowdown better than many other euro area countries.



Sources: WEO; IFS, Bloomberg; and staff estimates.
1/ ILO basis; levels, in percent.
2/ Twelve-month change in the EU Harmonized Index of Consumer Prices (HICP).
3/ Three-month average, ending in Dec. 2001, over corresponding period in 2000.
4/ Bank lending to residents other than monetary authorities and banking institutions. 12-month change, Dec 2001.
5/ As a share of total exports.

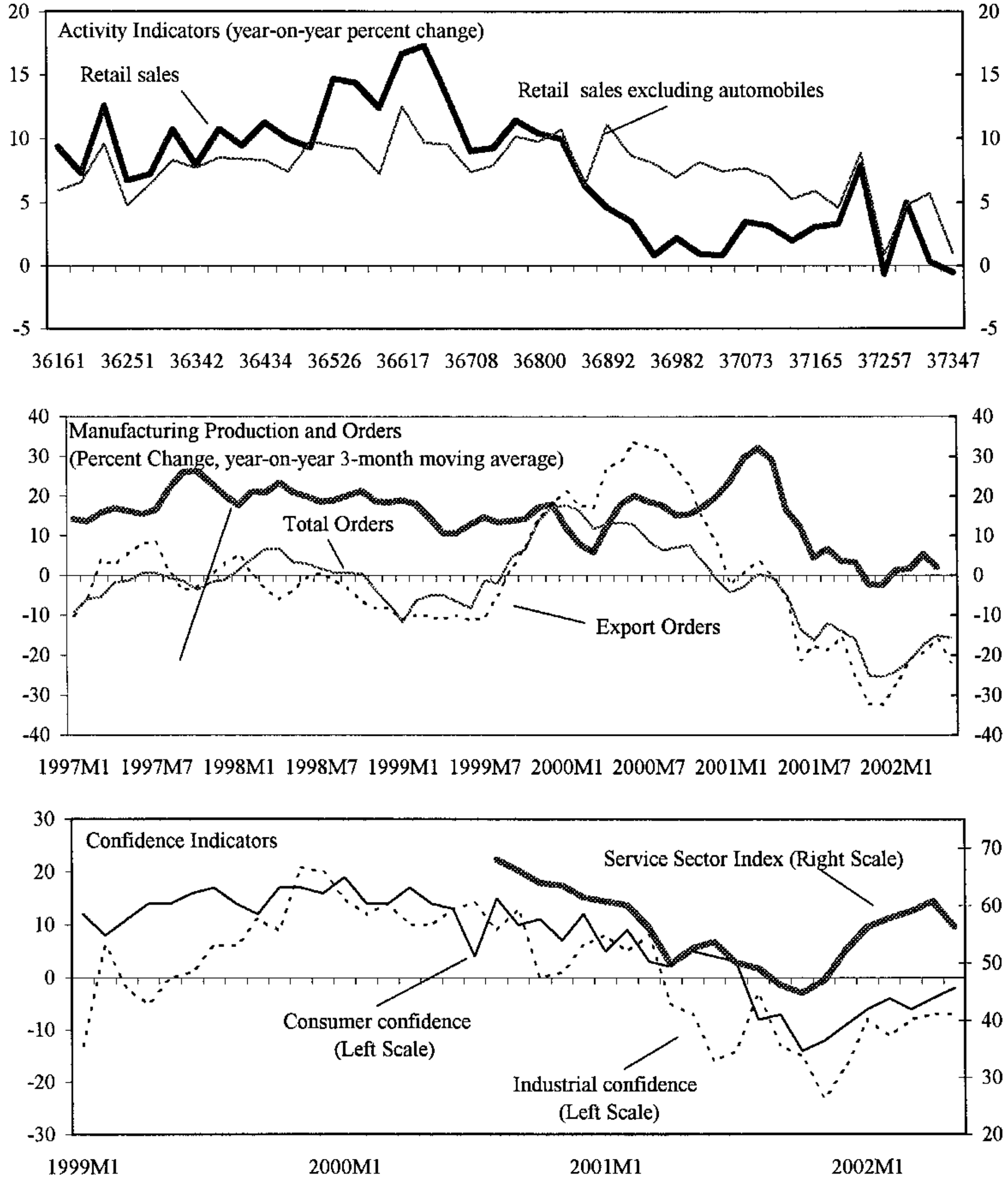
Figure 4. Asset and Consumer Prices



Sources: Central Statistical Office; IFS; Irish Permanent TSB.
1/ HICP from 1996 onwards, national CPI prior to that.

Figure 5. Ireland: High Frequency Indicators

Retail sales, manufacturing production, new orders, and confidence indices all suggested a recovery in early 2002, although some indicators have dipped recently.



Sources: Ireland CSO; NCB stock brokers; WEFA; amd IMF staff estimates.

the changed economic environment? (4) Given the growth slowdown, are there systemic asset market or financial sector risks? (5) How can structural policies contribute to sustaining medium-term growth?

II. Report on the Discussions

A. Why Did Ireland Weather the Global Slowdown Relatively Well?

6. **There was general agreement that the global slowdown in 2001 had brought a welcome easing of resource pressures, particularly in overheated sectors such as construction and housing.** Private investment fell, but output growth was sustained by private consumption—buoyed by low unemployment, strong wage growth, and tax cuts—and public spending (Table 2). Net exports continued to make a significant positive contribution to GDP growth, but taking net factor payments abroad into account, the net foreign balance made a zero contribution to GNP growth.

7. **Several factors contributed to this outcome:**

- The **weakness of the euro**, especially against sterling, limited the decline in external demand, particularly for the indigenous manufacturing sector. (The United Kingdom remains Ireland's single largest trading partner). Although unit labor costs rose markedly in the second half of 2001, the overall impact on competitiveness was minor, given past productivity gains and the weak nominal exchange rate (Figure 6).

- The **composition of external demand** was favorable. Exports of chemicals and pharmaceuticals, which comprise over 50 percent of manufacturing, remained strong. Moreover, although the ICT-related exports of US-owned multinationals were adversely affected, the employment share of these firms remained relatively small. In addition, strong consumption growth in the United Kingdom (along with strong sterling) buoyed the main export market for the employment-intensive indigenous manufacturing sector.

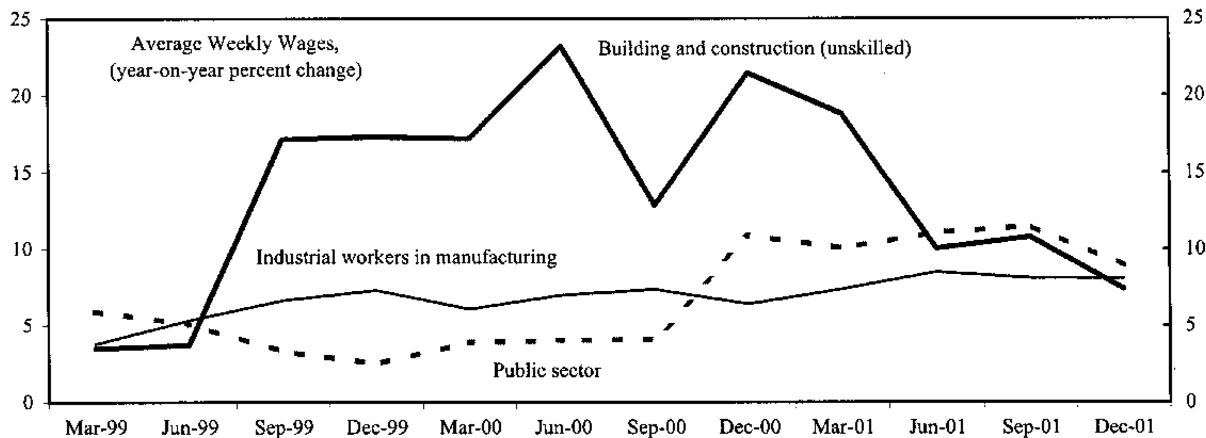
- **Macroeconomic policies** were supportive. Fiscal policy was relaxed by about 2¼ percent of GDP in 2001 reflecting both tax cuts and substantial spending increases. Monetary conditions were accommodating, with real interest rates turning negative as the ECB cut the policy rate by 150 basis points during 2001 (Figure 7).

- **Resource utilization and growth was high** prior to the shock. Thus, the expectation that the shock would be temporary and the tightness of the labor market seems to have led to some labor hoarding. Adjustment appears to have taken place mainly through lower growth of employment and profits, rather than through unemployment. Indeed, wages continued to grow rapidly.

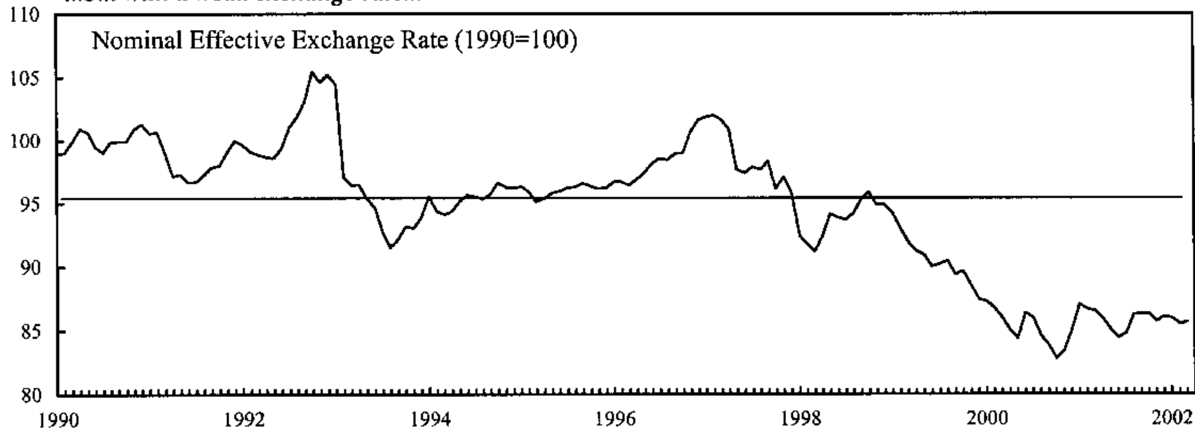
- The relatively **flexible labor supply** acted as a shock absorber. As employment growth slowed sharply, a near halving of labor force growth reflecting a leveling off of the participation rate resulted in only a marginal increase in unemployment (Figure 1).

Figure 6. Nominal and Real Exchange Rates

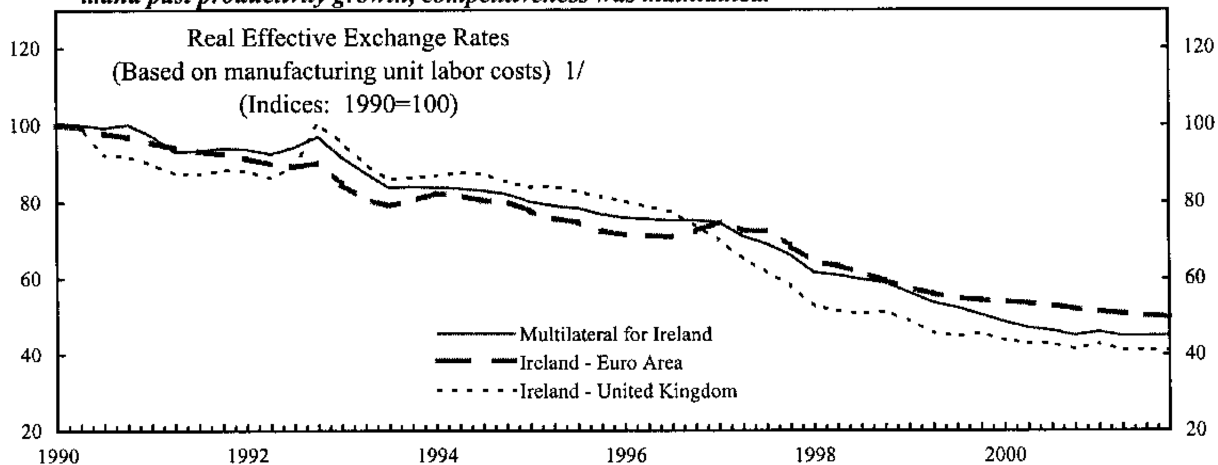
Wages continue to rise at a rapid clip, given still tight labor markets...



...but with a weak exchange rate...



...and past productivity growth, competitiveness was maintained.

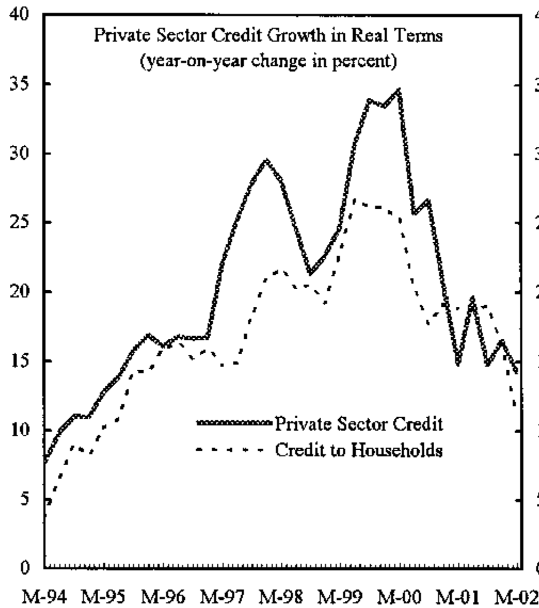


Sources: Central Statistical Office; IFS; and OECD.

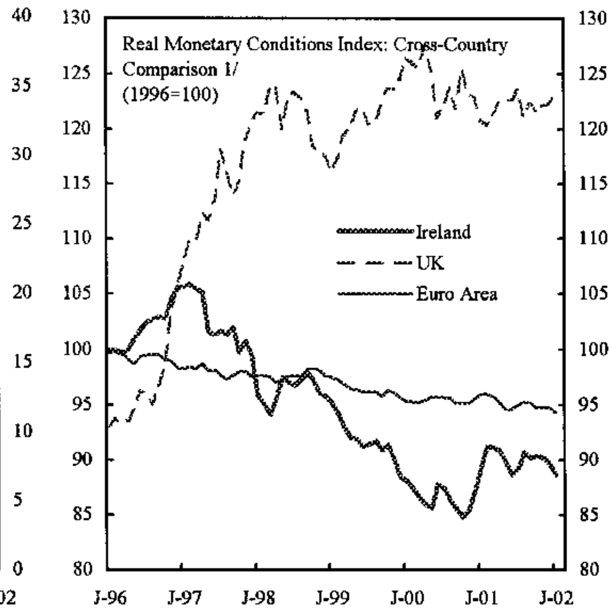
1/ With normalized productivity growth.

Figure 7. Ireland: Money, Credit, and Interest Rates

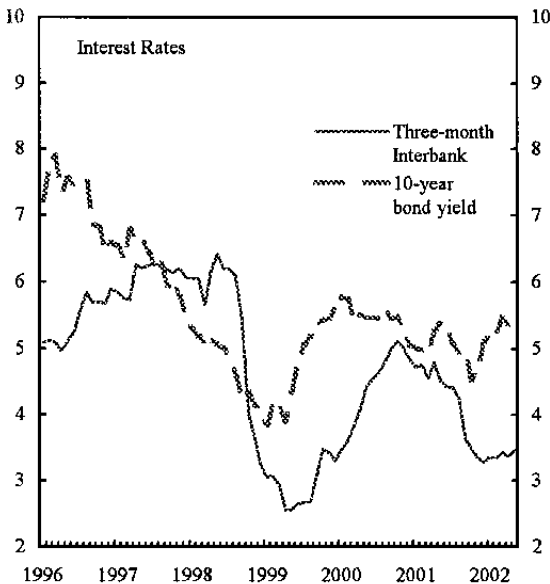
Credit slackened with the economic slowdown, albeit at still high levels.



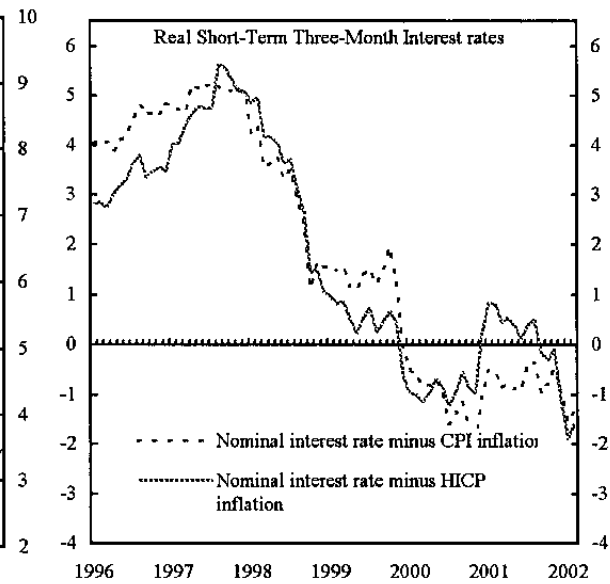
Real monetary conditions remained loose in 2001 (despite some tightening reflecting the dip of Irish inflation)...



...as euro-area interest rates fell...



...and real interest rates remained low or negative.



Sources: IMF, Central Bank of Ireland, and staff calculations.

1/ The index is defined as a weighted average of the percentage point changes in the real short-term interest rate and the real effective exchange rate from the base period. Relative weights are 4 to 1 for both Ireland and the United Kingdom. The appropriate weights for Ireland are uncertain given the unusually large size of trade relative to GDP. However, the broad conclusions about the evolution of monetary conditions in Ireland are not particularly sensitive to the choice of weights.

B. The Celtic Tiger Tamed?

8. **The authorities and staff broadly agreed that growth would pick up over the short-term, but not to levels experienced in recent years.** At the time of the discussions, the authorities projected GDP growth of 3.9 percent in 2002, somewhat higher than the staff's projection of 3.2 percent, reflecting expectations of a sharper rebound in the second half of the year (Tables 2 and 3). Both projections envisage output growth to reach almost 6 percent in 2003 and to move broadly in line with potential growth thereafter. Private consumption growth is projected to continue at a steady clip, fueled by low unemployment and strengthening consumer confidence. Given negative short-term real interest rates, monetary conditions are expected to remain easy in 2002–03, even if the ECB were to raise rates or the euro were to appreciate moderately. Export growth is projected to gather steam in mid-2002 as global demand picks up, but the recovery in investment would take somewhat longer. The narrowing output gap (Figure 8) and easing labor market pressures should lower price and wage inflation somewhat this year, the latter to a range of about 7–8 percent from approximately 10 percent in 2001.

9. **As in past years, the authorities were concerned that excessive wage growth could jeopardize competitiveness.** Staff analysis suggests that until last year rapid productivity growth had largely outstripped wage increases resulting in declining unit labor costs and sizeable gains in competitiveness.[1] However, cyclical factors and continued rapid wage growth led to an increase in unit labor costs in the second half of 2001, which is likely to continue this year, particularly for the indigenous companies whose productivity gains have tended to be lower. The mission noted that with Ireland approaching full employment and capacity constraints biting in certain sectors, some increase in unit labor costs and resulting loss of competitiveness was perhaps inevitable, given that this was a channel for cooling an overheating economy within a monetary union.[2] Barring further adverse shocks, the risk was limited that private sector wages would, by themselves, significantly overshoot levels compatible with a smooth adjustment, causing unemployment to rise. However, staff cautioned that excessive public sector wage growth was a substantial risk, with possible adverse spillover effects on private wages.

10. **A sudden appreciation of the euro, with its attendant loss in competitiveness, was broadly viewed as a significant risk to the outlook.** There was consensus—supported by staff analysis—that given their lower productivity growth and higher share of exports

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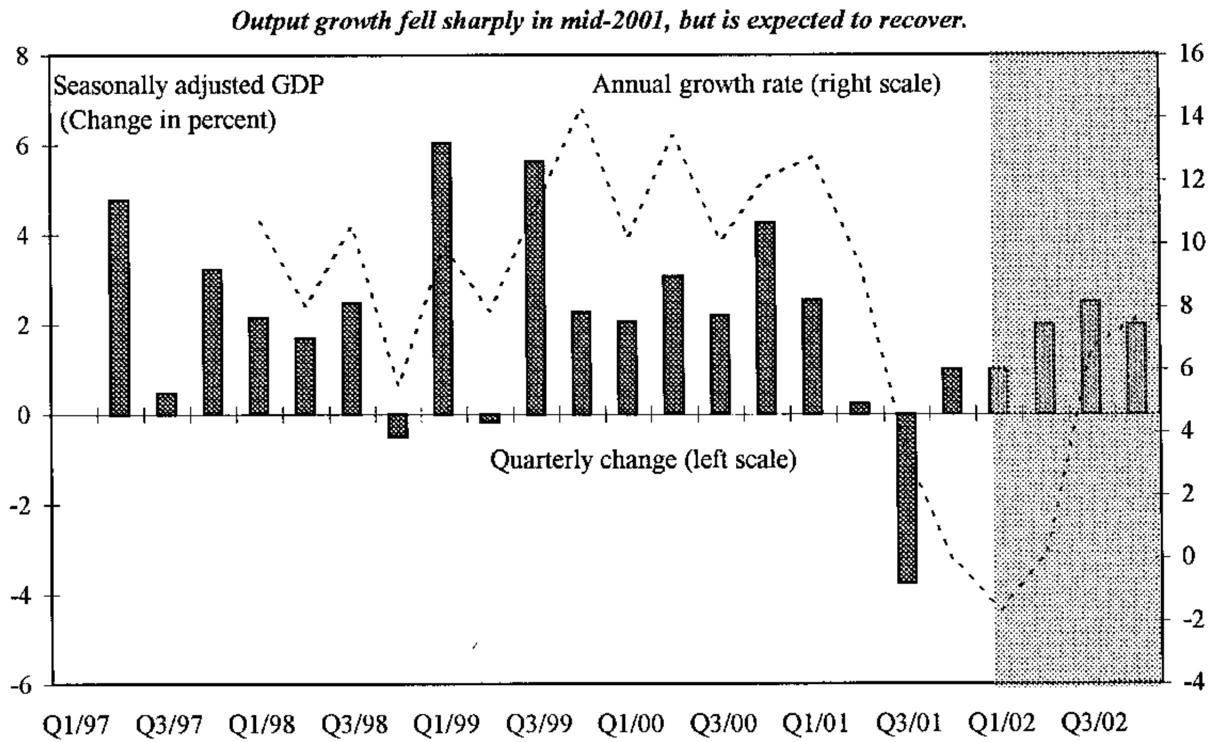
[1] See *Selected Issues* paper, "How Competitive is Irish Manufacturing?"

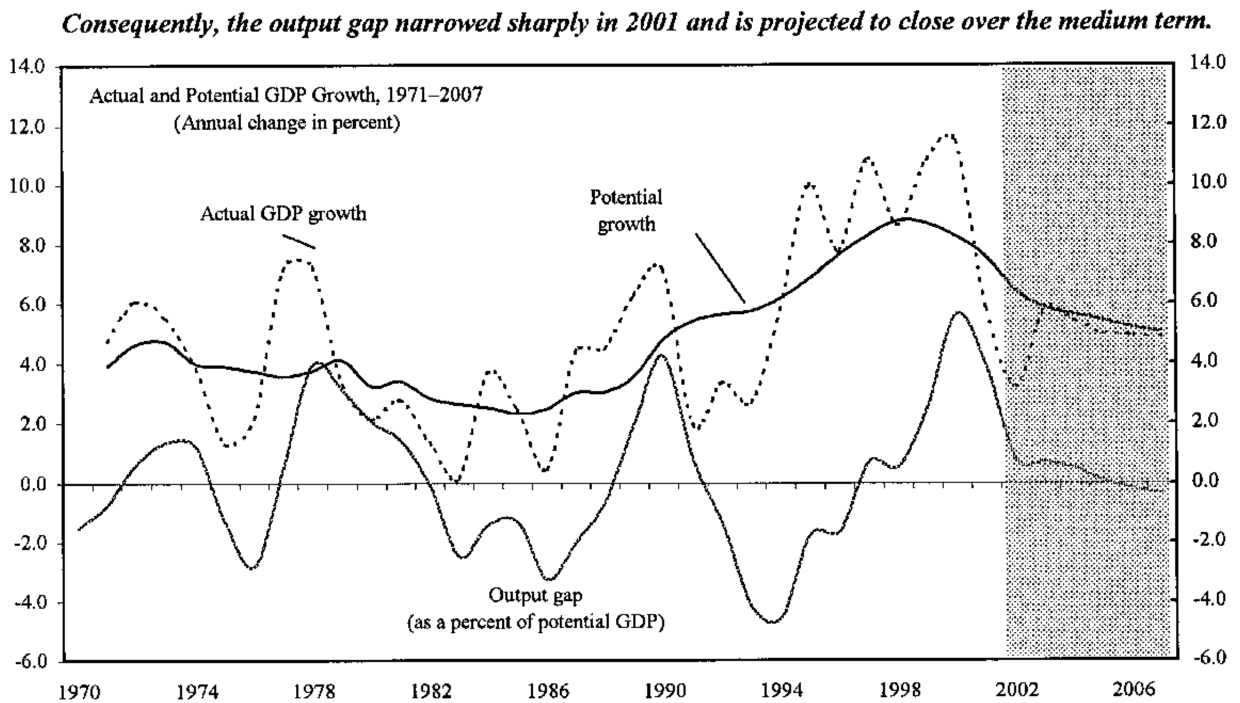
[2] Given Ireland's small, open economy and EMU membership, unit labor cost growth is a better gauge of overheating pressures than price inflation, which is heavily influenced by imports and erratic components, such as changes in indirect taxes. Past staff analysis suggests that Balassa-Samuelson effects could give rise to price and wage inflation differentials of about 1–2 percent above the euro area average (IMF Country Report No: 99/108).

Figure 8. Ireland: GDP and the Output Gap

Output growth fell sharply in mid-2001, but is expected to recover.



Consequently, the output gap narrowed sharply in 2001 and is projected to close over the medium term.



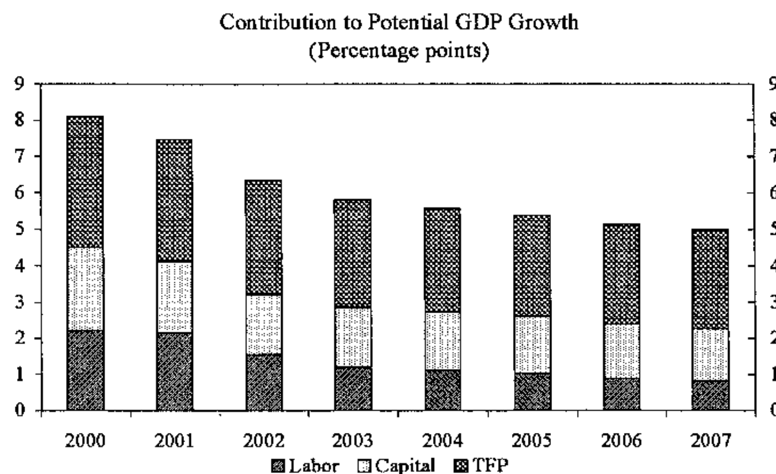
Sources: Central Statistical Office; ERSI; IMF; and staff estimates

outside the euro area, indigenous, employment-intensive, manufacturing sectors would be far more vulnerable to a euro appreciation, particularly against sterling, than the large multinationals.[3] To the extent that wages did not adjust quickly, such a shock could result in higher unemployment, thereby eroding the tax base as well as posing a risk—most likely manageable—to the financial sector.

11. **The authorities agreed there were other risks to the outlook, in particular:**

- the projected economic rebound in the second half of this year and in 2003 was highly dependent on the timing and magnitude of global recovery;
- there might be lagged unemployment effects from the 2001 slowdown, and if recovery were delayed, unemployment might rise further and confidence could fall;
- oil price increases and a potential rebound in house prices could feed into higher wage demands, posing a upside risk to inflation and a downside risk to competitiveness and growth.

12. **There was a widespread expectation that—following the recovery—output growth would trend down to more sustainable rates consistent with the slowing of potential growth from the very high rates in the 1990s.** Such a smooth adjustment path (Figure 8) is, of course, predicated on sound policies, most significantly, fiscal and wage policies. Estimates of Ireland's potential output growth are subject to an especially high degree of uncertainty given the flexible labor supply, lack of reliable estimates of the capital stock, and high and volatile rates of past total factor productivity



Source: Staff estimates.

[3] Standard measures of competitiveness, such as the unit labor cost based real exchange rate, indicate substantial gains in the late 1990s. However, staff estimates show that when output is weighted by employment—rather than production—shares, competitiveness in 2001 was broadly at the level in 1995. A 20 percent appreciation of the euro against the U.S. dollar and sterling would worsen the employment-based measure by about 10 percent assuming unchanged unit labor costs. See *Selected Issues* paper "How Competitive is Irish Manufacturing?"

growth. The authorities projected medium-term growth at about 5 percent per annum, consistent with staff projections, although some academics and analysts were somewhat more pessimistic. Much of the growth slowdown reflects lower labor force growth due to the sharp decline in the birth rate that began in the early 1980s and a leveling off of already-high participation rates, especially among younger women. Labor productivity growth is also likely to slow from the very high rates in the 1990s, given income convergence and the return of FDI to more normal levels. Staff stressed that structural policies—particularly affecting the growing service sector—will be key in sustaining strong productivity gains over the medium term.

C. Fiscal Policy: Adjusting to Slower Growth

Short-term fiscal policy

13. **There was agreement that the significantly weaker fiscal outcome in 2001 than budgeted was due to a combination of slower growth, past tax cuts, and rising spending pressures.** Apart from cyclical effects that caused tax revenues to fall, the factors that contributed to the budget excess were: (i) expenditure overruns, particularly on the wage bill and purchases of goods and services, partly related to healthcare; (ii) larger-than-expected revenue effects from past income tax cuts (frequent tax regime changes and demographic shifts made it difficult to forecast income tax receipts); (iii) overestimation of indirect tax receipts from automobile sales; (iv) temporary factors,

Fiscal Stance (General Government): 2000–02 1/
(In percent of potential GDP)

	2000 Act.	2001 Budg.	2001 Act.	2002 Budg.	2002 Staff
Structural balances					
Revenue 2/	35.5	35.6	34.4	34.7	34.4
Expenditure	33.4	33.9	34.5	35.4	35.4
Overall balance	2.1	1.7	-0.1	-0.7	-1.0
Fiscal impulse ("-" indicates expansion) 3/	**-0.6**	**-0.4**	**-2.2**	**-0.6**	**-0.9**
Memorandum item:					
Nominal overall balance	4.5	4.3	1.7	0.6	0.0

Sources: Department of Finance and staff estimates.
1/ Based on staff's methodology and estimates of output gap.
2/ Revenue excludes one-off receipt arising from euro changeover in 2002.
3/ Change in the structural balance (over the previous year's actual structural balance).

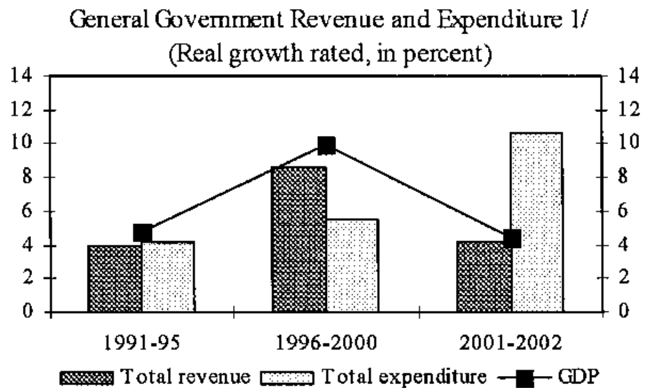
General Government Budget and Outturn for 2001; Selected Items
(In percent of GDP)

	Budget	Estimated Outturn	Cyclical component 1/	Non-cyclical component 2/
Total revenues	36.5	34.5	-0.8	-1.2
o/w total current revenues	33.8	32.3	-0.8	-0.7
Total expenditures	32.2	32.8	-0.2	0.8
o/w total current expenditures	26.6	27.5	-0.2	1.1
o/w compensation of employees	7.8	8.2	0.0	0.4
o/w goods and services	5.1	5.8	0.0	0.7
o/w government investment	4.4	4.1	0.0	-0.3
General government balance	4.3	1.7	-0.6	-2.0

Sources: Department of Finance and staff estimates.
1/ Part of the deviation between budget and outturn attribute to errors in forecasting nominal GDP growth, unemployment, and interest payments.
2/ The remaining deviation between budget and outturn after adjusting for forecasting errors noted above.

such as animal diseases and September 11. Staff expressed concern at the 2001 fiscal outcome—even if the expansionary stance may have been useful in supporting demand during the slowdown—because it reflected unexplained weaknesses in income tax receipts that could foreshadow lower structural revenues in future years and sizeable general government current expenditure overruns, a notable change from previous years.

General Government Revenue and Expenditure 1/
(Real growth rated, in percent)



Sources: Department of Finance; Central Statisical Office; and staff estimates.
1/ Revenues deflated by GDP-deflator, current spending by CPI and capital spending by capital goods-deflator.

14. **For 2002, staff stressed that the authorities should hold firmly to budgeted spending plans, particularly on current spending.** There was agreement that the fiscal stance should aim to be broadly neutral (i.e., a broadly unchanged cyclically-adjusted balance) in since this would avoid the drawbacks of attempting to run discretionary counter-cyclical fiscal policy in Ireland—other than to address serious overheating or recession, neither of which was currently likely.[4] Although the 2002 budget presented an apparently neutral stance, the authorities did not dispute the mission's assessment that, in fact, a fiscal expansion of some 1 percent of GDP was likely, taking into account a one-time transfer of central bank profits and the stronger fiscal outturn the previous year than anticipated at the time the 2002 budget was announced (Tables 4 and 5). There was a substantial risk of an even larger expansion given poor revenue performance through June which the authorities noted partly reflected the timing of tax measures and a higher-than-expected take up of a recently-introduced saving scheme that involved matching government contributions.[5] While recognizing these risks the authorities indicated, at the time of the discussions, that they expected revenue to perform close to budget.[6] Although the mission remained concerned about a revenue shortfall, it did

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[4] As noted in last year's staff report (IMF Country Report No: 01/139), drawbacks include the difficulties in judging Ireland's cyclical position—reflecting uncertainty regarding potential output—and the well-known lags in discretionary adjustments to fiscal policy.

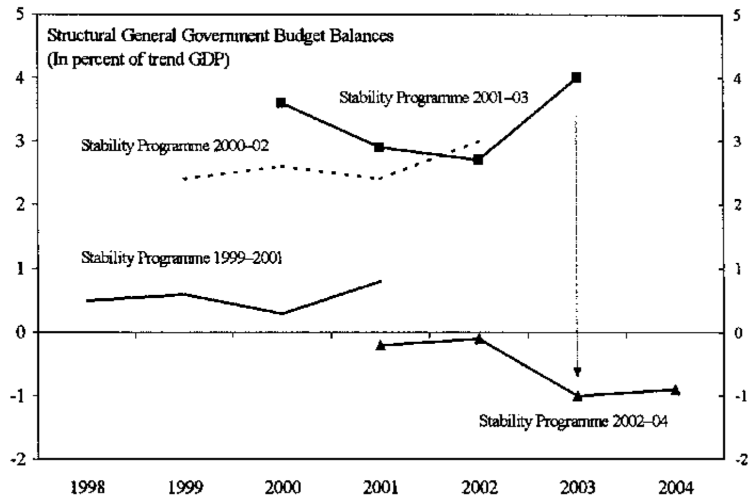
[5] Tax revenue in the first half of 2002 was similar to that in the same period last year, after adjusting for the receipt of June 2002 corporate taxes on July 1. Meeting the budget projection of an 8.6 percent increase in tax revenue for the year as a whole would require exceptional revenue growth in the latter half of 2002.

[6] In July, however, the government acknowledged that revenues could fall short of budget by 0.4 percent of GDP.

not press for offsetting mid-year measures, given the uncertainty regarding the domestic recovery and the still sound medium-term fiscal position. In view of the rapid spending increases in 2001–02, staff stressed that the fiscal stance should not be allowed to expand beyond the projected 1 percent of GDP—particularly on account of expenditure overruns—and received assurances that spending would be kept firmly within budget.

Medium-term fiscal policy

15. **Discussions focused on the striking downward shift in the path for the medium-term structural balance as presented in the government's 2002 Stability Programme.** The structural balance at the end of the forecast period is now projected at a deficit of 1 percent of GDP, compared with a surplus of 4 percent of GDP in the previous Programme (Table 5).[7] The deterioration reflects higher future expenditure growth on top of the sharp increase in spending in 2001, and lower structural revenue growth. Ireland's fiscal position remains fundamentally sound, but spending pressures are substantial and there is a risk that spending may exceed the already generous increases envisaged in the Stability Programme. Infrastructure needs are acute and public pressure to improve healthcare and education is mounting, as is union pressure for higher public sector wages. The recently-announced National Health Strategy—not yet substantially incorporated into budget projections—was estimated to raise healthcare expenditures by EUR 12.7 billion (equivalent to 11 percent of 2001 GDP) cumulative over 10 years. In addition, the public wage bill was widely expected to rise following the June 2002 report on the public wage benchmarking exercise.[8]



Source: Department of Finance.

[7] In its opinion on Ireland's 2002 Stability Programme, the European Commission noted "with concern" that the new projections might not respect the close-to-balance requirement of the Stability and Growth Pact (SGP), but added that if the contingency provisions of some 1 percent of GDP were not used, the requirement would be broadly respected.

[8] The report was released on June 30 (after the consultation discussions took place). The government's initial assessment was that full implementation of the recommendations would result in a full year cost of over EUR 1 billion (¾ percent of 2002 GDP) in current terms. This could use up most of the approximately 1 percent of GDP in contingencies built into the 2002 Stability Programme.

16. **The authorities emphasized their commitment to the SGP, particularly zero balance over the medium term.** They could not as yet be specific on how the commitment would be delivered, pending the formation of a new government in June, following general elections. Staff projections suggest that if healthcare spending were to rise as envisaged by the Health Strategy, the fiscal deficit could rise to about 2 percent of GDP over the next few years, while if the temporary boost to revenues provided by the 5-year phased change of the corporate tax year (due to end in 2006) were stripped out, the underlying deficit would be higher by an additional 0.6 percent of GDP.[9] Aiming for an underlying zero balance under this policy scenario would therefore require an additional tax effort or lower spending of 2½ percent of GDP a year over the medium term. Moreover, the required fiscal effort would increase further to the extent that the full costs and phasing in of the benchmarking recommendations, not as yet agreed, exceed the contingencies built into the baseline.

Real Growth of Structural Revenue and Expenditure 1/
(In percent)

	2000	2001	2002	2003	2004
Stability Programme 2001–03					
Revenue	6.8	5.1	8.0	8.2	...
Expenditure	6.2	7.4	8.7	3.6	...
Potential GDP	8.1	7.9	7.7	7.4	...
Stability Programme 2002–04 2/					
Revenue 2/	...	4.8	6.7	4.2	6.2
Expenditure	...	14.4	7.9	5.5	5.9
Potential GDP	...	7.4	7.1	6.8	6.5

Sources: Department of Finance and staff estimates
1/ Based on Department of Finance data and staff's methodology for calculating structural revenue. Structural expenditure estimated as a residual. Due to acccounting differences, revenue and expenditure growth between the two Programmes may not be fully comparable Contingency provisions treated as expenditure.
2/ In 2002, excludes windfall gain from the euro changeover.

17. **Staff recommended aiming for structural fiscal balance over the medium-term.**[10] The required adjustment was modest (some 1 percent of GDP over the next few years) and should begin as soon as the economic recovery was well established, including possibly in 2003. The mission noted that, on one hand, there were arguments to suggest that Ireland could afford to run a small structural deficit over the medium-term: the public debt stock was low; age-related spending pressures were limited in the foreseeable future; and public investment needs were high. On the other hand, there were compelling reasons for prudence:

- confidence in the public finances should be sustained to continue to support private investment and attract foreign capital inflows;

- fiscal prospects were uncertain since structural revenues may well turn out lower than anticipated (due to recent tax reforms and uncertainty over potential output growth) and existing spending commitments may prove more costly than expected; and

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[9] See *Selected Issues* paper, "Ireland: Medium-Term Fiscal Scenarios."

[10] Since medium-term output is expected to trend close to potential, in practice, this would be similar to the SGP requirement of nominal balance over the medium term.

- adequate room should be left for the operation of the automatic stabilizers and possibly discretionary action, without breaching the SGP's 3 percent deficit rule, in the event of an adverse shock.

18. **Staff suggested that a transparent, formal medium-term fiscal framework would be useful in improving policy predictability and prioritizing competing budget pressures.** Such a framework—set at the general government level—could comprise three elements: (i) a set of overall fiscal constraints or rules such as those provided by the SGP or, say, a requirement for structural balance over the medium term; (ii) transparent rolling five-year budget projections that set out tax and expenditure plans and showed how the overall fiscal constraint would be met; and (iii) a medium-term expenditure framework that operationalized these projections, for instance, via binding multi-year (e.g., on a rolling 3–4 year basis) nominal departmental spending limits on non-cyclical primary expenditures, which would be subject to periodic reevaluation. The framework could also include safeguards to ensure that budget pressures do not squeeze capital expenditures (for instance, by not allowing saving on capital spending in the multi-year departmental budgets to be used for current spending) and periodic ex-post reviews to explain publicly whether medium-term fiscal targets were achieved and if not, the reasons.

19. **The authorities were open to the mission's suggestions for a medium-term fiscal framework.** They had begun to develop rolling multi-year spending envelopes for certain departments, which would complement the multi-year investment projections in the National Development Plan (NDP) and be compatible with the national wage agreements.[11] They agreed that capital spending should be protected from budget pressure, which would require adopting stricter, national accounts definitions in the fiscal accounts to minimize scope for redefining spending categories. In addition, budget accounting would need to be enhanced to reflect accurately recurrent spending costs associated with the completion of public investment projects, and government information systems would need to be developed to permit resource budgeting or accrual accounting.

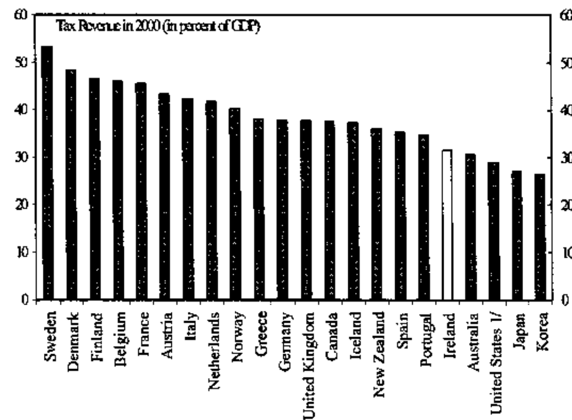
20. **Concerns about the quality of public spending were widespread.** Despite substantial expenditure increases during the 1990s, public dissatisfaction with healthcare, education, and the physical infrastructure remained high.[12] Many observers noted that public

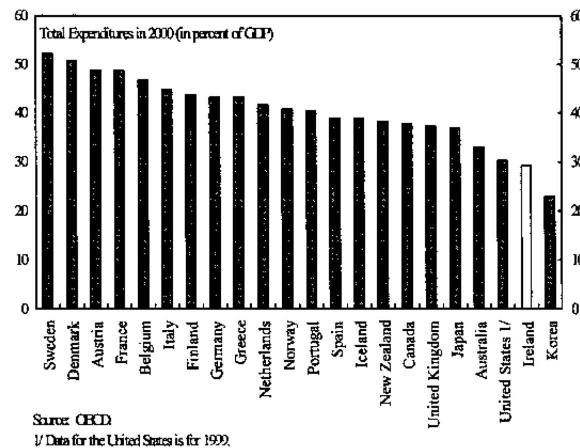
[11] The European Council expressed regret that Ireland's Stability Programme did not include plans to introduce a medium-term framework to guide public spending or to improve expenditure control.

[12] For instance, a report on the healthcare system (*Value for Money Audit of the Irish Health System*, Deloitte & Touche, 2001), noted that public health expenditure increased by 260 percent in nominal terms during 1990–2001 and "...yet the perception is that it has, at best, only resulted in a modest improvement in services." Much of the increase has been absorbed in pay, non-pay inflation, and the increased cost of demand-led schemes, with extremely low investment in relation to maintaining the capital infrastructure and a minimal funding of information systems (p. 7).

projects were often not properly costed at the outset, and reviews tended to be geared to monitoring spending relative to budget, rather than in relation to output. The authorities acknowledged that expenditure reforms were needed and pointed to efforts underway, including a Strategic Management Initiative for the public service, public-private partnerships (PPPs), improvements to public sector output data, and the close monitoring of major capital projects, which, nonetheless, had experienced significant cost overruns partly reflecting high construction inflation. Staff encouraged subjecting spending decisions—including within established programs like the NDP—to rigorous scrutiny for value for money and urged caution in increasing spending as rapidly as presently projected.

21. **The mission stressed that greater transparency regarding budget performance was key for increasing accountability and maintaining policy credibility.** Switching budget and Stability Programme data to a national accounts basis would allow a consistent set of fiscal accounts to be obtained across time and levels of government. In addition, analyses of budget outcomes in relation to projections would enhance public understanding of fiscal developments. Publishing cost-benefit analyses and ex-post "value for money" reviews of public projects would also be useful. The authorities noted that they published departmental expenditure reviews and were considering publishing comprehensive tax expenditure estimates. They could not commit to undertaking a fiscal ROSC—to identify other areas where transparency could be improved—in the coming year due to resource constraints.





Source: OECD.
1/ Data for the United States is for 1999.

22. **Given spending pressures, the authorities noted that tax increases would be among the alternatives available to the incoming government.** They agreed that base broadening and greater resort to user fees would be preferable to rate increases in the interests of minimizing distortions. International comparisons suggest that Ireland has low tax and spending ratios. The taxation of capital is relatively low while that of consumption is relatively high.[13] Labor taxation, while low compared with continental

[13] See *Selected Issues* paper, "Ireland's Tax Effort—An International Perspective."

Europe, is at the level of countries such as the United States, the United Kingdom, and Canada that also have relatively low social security tax rates, broadly corresponding to low benefit levels. Thus if Ireland intends to maintain a low (but broad-based) corporate tax, the choices for increasing tax revenues would inevitably fall on labor or consumption. In this context, the mission said that options included: (i) reducing tax expenditures, following a comprehensive assessment—for instance, abolishing mortgage interest deductibility on income taxes; (ii) eliminating VAT zero rating and unifying the remaining 12½ percent rate and the standard 21 percent rate in a revenue-enhancing manner (with offsetting transfers to the poor and appropriate adjustments to excise taxes); and (iii) introducing a property tax at the local level. Staff cautioned against excessive increases in the marginal rate of labor taxation that could discourage labor force participation and damage competitiveness, particularly given the widely-expressed desire to switch to higher-skill export activities.

D. Wage Policy: Maintaining Flexibility and Preventing Instability

23. **Views varied on the usefulness of another national wage agreement (NWA), particularly given tight labor markets and limited resources for further fiscal concessions.**[14] It was generally agreed that NWAs, in practice, allowed a high degree of wage flexibility, although downward flexibility in the event of a shock had yet to be widely tested. Many employers found the wage norms saved them the burden of negotiating wages individually, but were dissatisfied with the magnitude of recent wage hikes. Unions noted the need for agreements to move beyond wage norms to broader social commitments. The authorities considered that NWAs had allowed wage moderation, limited industrial disputes, and provided a useful degree of consensus on taxation and spending. They saw a continuing role for them in the future, for instance, in obtaining agreement on budget cuts or implementing the results of the public wage benchmarking exercise. The mission, however, noted that NWAs create the risk of delaying downward wage adjustment in the event of an adverse shock and of compressing the wage structure, hindering economic efficiency. Staff argued that, at a minimum, any future NWA should not include fiscal concessions: budget pressures precluded tax cuts, and negotiating expenditure commitments militated against the suggested emphasis on value for money criteria in public spending decisions.

24. **The ongoing benchmarking exercise elicited concerns relating to whether the results would reflect objective criteria and to the implications for public spending.** Private analysts noted that it would be important for the assessments to reflect the greater job security, pension entitlements, and other non-pecuniary benefits of public employment, rather than simple wage comparisons. The authorities felt that any resulting wage changes may need to be phased in given budget constraints. Staff agreed, noting that offsetting cuts elsewhere would also be needed if changes were large. To the extent that the outcome

[14] The present agreement is due to expire in the coming year. Its terms and the experience under the NWAs are discussed in IMF Country Report No: 01/139, including the practice of linking wage moderation to income tax reductions and, latterly, to expenditure commitments.

successfully establishes market-based pay relativities (which should include relative wage declines in some skill categories), it could form the basis for an ongoing rules-based public pay system that would keep public and private compensation aligned, thus reducing the need for negotiations via NWAs.[15]

E. Are There Major Housing Market or Financial Sector Risks?

25. **There was general consensus on a soft landing in property prices after years of rapid growth.** The surge in house prices in the 1990s partly reflected supply constraints and strong demand stemming from a rapid rate of household formation, rising real incomes, and a comparatively low housing stock (still the lowest in the EU). Following a decline late last year, house prices had begun to recover, aided by tax measures (Figure 4).[16] Most analysts considered that the annual flow of new housing supply was now in line with the increase in demand stemming from demographic trends, and saw little risk of a price bubble reemerging. The mission noted that the office and industrial real estate markets, where vacancy rates appear to have increased recently, bear close watching as they would be especially vulnerable to a slower-than-expected recovery.

26. **The authorities considered the financial system to be well capitalized and sound.** Banks' greater caution on extending housing loans in 2000–01 had contributed to the limited adverse effects, thus far, from the recent growth slowdown (Table 6).[17] Stress tests revealed that banks were more vulnerable to increases in unemployment than to a fall in house prices, and thus a possible appreciation of the euro could be a particular risk. These views were echoed by financial market analysts. Staff observed that banks' exposure to housing and commercial real estate remained high (some 60 percent of loans to the private nonfinancial

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[15] The benchmarking report, which was released after the consultation discussions were concluded, recommended pay increases ranging between 2 and 25 percent with an average increase of 8.9 percent. Union reaction has varied, with some dissatisfaction expressed at the level of increases and the tendency for management grades to receive larger increases than other workers. Negotiations over acceptance of the recommendations and the phasing in of pay adjustments are expected to begin shortly.

[16] In 2000, stamp duties were increased and mortgage interest deductibility against rental income was eliminated to withdraw demand pressure in the housing market. The 2002 budget reversed these measures after prices softened.

[17] See *Selected Issues* paper, "Ireland's Financial System—Structure and Performance." The 2000 FSAP noted that Ireland's financial system was well capitalized and adequately supervised, with a high degree of compliance with international standards. Its recommendations are summarized in IMF Country Report No: 01/139.

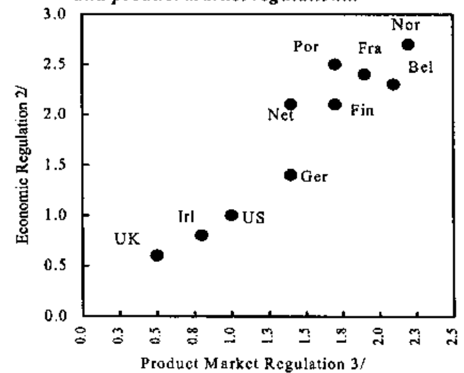
sector at end-2001)[18] and continued supervisory vigilance was needed if these markets do not recover as expected, or if unemployment or ICT-related bankruptcies pick up, reflecting cyclical lags or the materialization of downside risks to the outlook. The authorities noted the ongoing strengthening of the central bank's forward-looking analysis of systemic risks—one of the recommendations of the 2000 FSAP. Recent actions included establishment of a financial stability coordination committee, publication of a biannual financial stability report, and ongoing research to identify a set of macro- and micro-prudential indicators of systemic risk for Ireland. Staff noted that pending the results of this research it would be useful to monitor a standard set of such indicators in a timely manner.

27. **The legislation for the unification of financial sector regulation had been submitted to Parliament and arrangements for the transition put in place.** Following up a recommendation of the 2000 FSAP, staff underscored the need to strengthen insurance supervision, particularly given global profit pressures on insurers and reinsurers. The authorities noted that this would have to await the establishment of the single regulator, most likely in the first half of 2003.

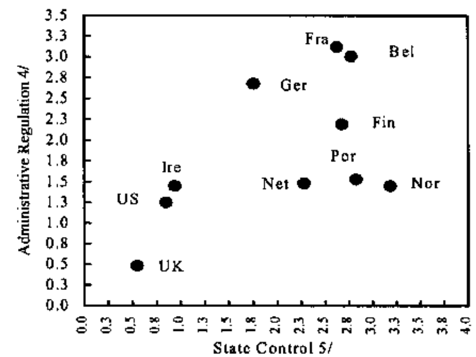
F. Structural Policies: Improving Competition to Increase Service Sector Productivity

28. **The recently strengthened Competition Authority is attempting to increase domestic competition through regulatory reform.** Officials were working on a number of fronts—particularly electricity, urban bus transportation, and retail services. They saw the divestiture of electricity generation from transmission and, possibly, greater resort to long-term private management contracts as essential for improving performance in the electricity sector. Similarly, the periodic tendering of local bus routes would enhance competition in domestic transport. There were substantial political obstacles in each of these areas, particularly from vested interests represented on boards reviewing regulatory reform and

Following notable progress in the 1990s, Ireland ranks above the euro area on many structural indicators 1/, including economic and product market regulation...



...but still lags the UK and US on state control and administrative regulation



Source: OECD.
1/ Lower score implies lower structural impediments.
2/ Regulation of economic structure, economic behavior and competition.
3/ Inward and outward oriented policies.
4/ Administrative burden for startups, regulatory and administrative capacity.
5/ Public ownership, public involvement in business operations.

[18] See Table 6. This is equivalent to about 42 percent of total loans to the private sector, including to financial intermediaries.

from public sector unions. Other observers also noted the existence of restrictive labor practices in professional services and the public sector, with the latter possibly contributing to excessive wage growth for some public employees.[19]

29. **Staff observed that there was still scope for increasing the role of the private sector in the economy.** Privatization had progressed in some areas such as banking and telecommunication, but further possibilities remained (e.g., air transport, airports). In addition, private provision of public services could be expanded, for instance, in such areas as healthcare and prisons, including via PPPs, which at present seemed concentrated in infrastructure projects. Staff noted that exposing the public sector to competition through privatization and deregulation was an important means of tightening the linkage between its wages and productivity.

G. Other Issues

30. Ireland is a signatory to the OECD **anti-bribery** convention, and the authorities expect ratification to be completed over coming months. Ireland is also a member of the FATF and party to the principal international treaties and conventions on **money laundering**. It has signed the International Convention for the Suppression of **Terrorist Financing** and is preparing enacting legislation.

31. **The authorities were prioritizing improvements to Ireland's statistics to meet international requirements.** They were working to improve the timeliness and quality of national income accounts data, prepare data on the international investment position, meet the standard 3-month SDDS reporting lag for balance of payments data, and develop a quarterly earnings series. Staff noted that the development of balance sheet data—on households and other sectors—should also be reintroduced to the priorities (Appendix II).

32. **The authorities indicated their intention to raise official development assistance** to the 0.7 percent U.N. target by 2007. Accordingly, ODA was increased substantially to 0.4 percent of GNP in 2002.

III. Staff Appraisal

33. **The remarkable performance of the Irish economy over the past decade owes much to a long record of sound economic policies.** Sustained fiscal consolidation, wage moderation, EU membership, and a policy environment conducive to FDI has spurred rapid income and employment growth. In recent years, improvements to the income tax structure have increased returns to work, while fiscal surpluses and EMU participation have boosted business and consumer confidence.

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[19] The Deloitte and Touche report, cited above, notes the professional barriers and structures in the healthcare sector, including the reluctance of some professional groups to "relinquish" some lower-skill tasks, thus artificially increasing the groups' relative scarcity (pp. 186–188).

34. **The economic outlook is broadly favorable, but risks remain.** The growth slowdown in 2001 appears to have facilitated a soft landing from the previously strong cyclical position. Activity is projected to recover with the rebound in world demand in the second half of 2002 and thereafter to slow in line with the expansion of potential output. In the short term, prospects for a global recovery remain uncertain. Moreover, a possible euro strengthening could adversely affect competitiveness and employment, particularly in traditional industries, and pose a risk—albeit likely a manageable one—to the financial sector. Inflation pressures are broadly in line with Ireland's comparatively high productivity growth in tradables, but public sector wage pressures could undermine medium-term competitiveness and output growth, particularly if they spill over to the private sector.

35. **The new government faces some stark policy choices.** Exceptional labor productivity growth in the past softened fiscal constraints and afforded sizeable wage increases without loss of competitiveness. With the economy now at full employment and more subdued prospects for productivity growth, difficult choices will have to be made—on fiscal policy: whether to maintain low taxes and spending and whether to borrow for public investment; on wage policy: how to ensure equitable growth while maintaining the labor market discipline essential for a small open economy; and on structural policies: how to curb the power of entrenched incumbents in order to enhance domestic competition.

36. **In the short-term, fiscal policy should be broadly neutral.** The materialization of downside risks to the outlook—unless extreme—would have to be met with wage adjustment, rather than discretionary fiscal policy changes. Spending should thus be kept to a predictable path, even if revenues are highly sensitive to cyclical conditions. Therefore, the apparent structural revenue decline and general government expenditure overruns in 2001 are of concern, especially if they are a harbinger of a further deterioration in the structural fiscal position. Given such concerns and the already expansionary stance in 2002 (after adjusting for one-time measures), as well as the risk of revenue underperformance, it will be critical to hold general government spending firmly to budgeted amounts this year. Fiscal policy should, at a minimum, be neutral in 2003, barring any large economic shocks.

37. **Over the medium term, the general government position should be moved into structural balance.** There are several reasons for a prudent fiscal policy: sustaining investor confidence in order to continue to attract FDI; uncertain fiscal prospects—lower structural revenues and more costly spending commitments than currently expected; and, in the event of an adverse shock, adequate room for automatic stabilizers to operate and possibly also for discretionary action, without breaching the SGP's 3 percent deficit limit.

38. **A formal medium-term fiscal framework—at the level of the general government—would be useful for improving policy predictability.** Such a framework could include an overall fiscal constraint; five-year budget projections; and most importantly, an expenditure framework comprising multi-year nominal departmental spending limits on non-cyclical primary expenditures and safeguards on capital expenditures. The steps being taken to develop multi-year departmental spending envelopes that could evolve into such a framework are therefore most welcome.

39. **Caution in the speed at which spending is increased and in the selection of public spending projects will be essential, to avoid incurring significant inefficiencies.** Existing and new spending plans should be comprehensively reviewed on a zero base to evaluate the most efficient means of addressing public needs. All spending programs should be realistically costed and assessed on rigorous value for money criteria, with clearly defined, monitorable outputs. The use of PPPs is welcome, and private sector involvement in public service provision should be further enhanced.

40. **Greater transparency will be key for the successful operation of a medium-term fiscal framework.** It would be useful to publish regularly spending program evaluations; more detailed budget projections and consistent fiscal accounts on a national accounts basis, including analyses of outcomes in relation to projections; and current-cost estimates of outstanding tax expenditures. The authorities are encouraged to undertake a fiscal ROSC to identify ways to further improve fiscal transparency.

41. **Should a strong case emerge for additional spending, it will be necessary to find efficient sources of additional tax revenue.** Measures to widen the tax base by minimizing exemptions and closing loopholes would be preferable to increasing tax rates. Greater scope for user fees should also be sought. In both cases, any resulting adverse impact on the poor could be offset by targeted transfers. Excessive increases in marginal taxes on labor should be avoided, given possible adverse effects on labor supply and competitiveness.

42. **With limited fiscal resources, any future wage agreement should not include fiscal concessions.** Negotiating spending commitments runs counter to the suggested improvements in public expenditure management. Dialogue may still be useful to maintain social consensus and establish a wage norm, provided that wages are permitted to reflect market forces, including on the downside and across skill categories. Public sector compensation should be aligned with that in comparable private sector jobs, in the context of departmental spending envelopes.

43. **The level of capitalization of the banking system appears to provide an adequate buffer against moderate risks to asset quality.** Nevertheless, continued supervisory vigilance is required to ensure that capital and provisions remain adequate in the event of any unexpectedly large increases in unemployment or ICT-related bankruptcies, or deterioration in property prices. Expeditious efforts to enhance the timely monitoring of forward-looking, systemic risks, to pass and implement legislation for the unification of financial sector regulation, and to strengthen insurance supervision will be important to enhance prudential supervision and regulation of the financial system.

44. **Strengthening competition—especially in services—through privatization and regulatory reform is key to securing a high sustainable growth path.** With the weight of services in the economy growing as income rises, efficiency gains in this area will be critical for maintaining overall productivity growth. The strengthening of the Competition Authority is welcome, and should be complemented with further political support to the Authority's

efforts to liberalize regulatory restrictions, limit the influence of vested interests, and reduce anti-competitive practices, including in professional services and the public sector.

45. Good progress has been made over the past year in the provision of **statistics** and the priority now should be to further improve the timeliness and coverage of economic data, particularly on earnings and sectoral balance sheets.

46. The authorities' substantial progress and commitment towards achieving the U.N.'s **ODA target** by 2007 is welcome.

47. It is proposed that the next Article IV consultation be held on the standard 12-month cycle.

Table 1. Ireland: Selected Economic Indicators

(Annual change unless otherwise stated)

	1998	1999	2000	2001	2002 Proj.	2003 Proj.
National accounts (constant prices) 1/						
GNP	7.9	8.2	10.4	5.0	3.0	4.7
Net foreign balance 2/	-2.3	0.6	0.5	0.0	0.4	0.1
GDP	8.6	10.9	11.5	5.9	3.2	5.8
Domestic demand	9.4	7.0	9.2	3.9	2.8	4.5
Private consumption	7.3	8.2	9.9	4.8	4.5	4.5
Public consumption	5.5	6.5	5.4	5.4	5.5	4.1
Gross fixed investment	16.5	14.0	7.0	0.5	-1.5	5.0
Exports of goods and services	21.4	15.7	17.8	8.4	4.5	10.0
Imports of goods and services	25.8	11.9	16.6	7.7	4.0	9.8
Prices, wages and employment						
Harmonized index of consumer prices (annual average)	2.2	2.5	5.3	4.0	4.4	3.0
Average hourly earnings , manufacturing	5.0	5.6	6.2	10.3	...	...
Output, manufacturing 3/	21.3	15.0	15.7	10.2	...	...
Unit wage costs (manufacturing) 3/	-11.8	-9.0	-4.7	-1.8	...	...
GNP/Employment 4/	-0.4	1.7	5.5	1.7	1.2	3.2
Employment 4/	8.3	6.4	5.0	2.7	1.8	1.5
Unemployment rate (in percent)	7.4	5.6	4.3	3.9	4.5	4.7
Money and credit (end-period)						
M3E 5/	18.1	...	14.7	17.2	...	...
Private sector credit 6/	22.6	33.5	20.6	16.5	...	...
Public finance (in percent of GDP)						
General government balance 7/	2.3	4.1	4.5	1.7	0.0	-0.7
Primary balance 7/	5.1	6.0	6.1	2.8	1.1	0.5
General government debt	55.1	49.6	39.0	36.5	34.9	33.9
Balance of payments						
Balance of goods and services (Percent of GDP)	11.4	13.9	14.1	14.9	14.9	15.3
Current account (Percent of GDP)	0.9	0.4	-0.6	-1.0	-0.8	-1.1
Official reserves (In billions of SDRs, end of period.)	6.7	3.9	4.1	4.2	...	...
Effective exchange rates (1995=100, annual average)						
Nominal	97.3	94.0	88.3	89.2	88.9 8/	...
Real (CPI based)	96.8	93.9	90.9	94.3	96.0 8/	...
Memorandum items (2001)						
Area	70.3 thousand square kilometers					
Population	3.84 million					
Natural rate of increase (percent change)	0.67					
GDP per capita (SDRs) 2001	21, 131					

Sources: Department of Finance; Central Bank of Ireland; IMF, International Financial Statistics; and staff calculations.

1/ Based on National Income and Expenditure, compiled in accordance with the new European System of National Accounts (ESA 95).
2/ Contribution of net exports and net factor incomes to GNP growth.
3/ Underlying productivity growth data may be overstated because of problems related to the measurement of output produced by multinational companies operating in Ireland.
4/ Data up to 2001 are based on the second quarter of the year to maintain comparability, whereas the forecasts are for annual averages.
5/ M3E was discontinued in December 1998. The methodology for calculation of Ireland's contribution to the Euro area money supply was amended in January 2000.
6/ Headline change, which includes the effects of transactions between credit institutions and non-bank international financial companies.
7/ Estimated prior to allocations for financing of future pensions liabilities and one-off expenditures, but including contingency provision for 2003.
8/ End-March 2002.

Table 2. Contribution to GDP Growth
(Percentage points)

	1999	2000	2001	of which:		2002
				1st half	2nd half	
Private consumption	4.3	5.1	2.4	2.4	2.5	2.3
Public consumption	0.9	0.7	0.6	0.6	0.7	0.7
Fixed investment	2.9	1.5	0.1	1.3	-1.0	-0.3
Private	2.0	0.8	-0.4	...	...	-0.5
o/w residential investment	0.7	0.4	0.3	...	...	-0.1
Public	0.5	0.7	0.6	...	...	0.2
Change in stocks	-1.9	0.6	0.1	-0.5	0.6	-0.3
Exports	14.8	17.5	8.7	16.2	1.7	4.8
Imports	-9.8	-13.9	-6.7	-9.9	-3.8	-3.6
Net exports	5.0	3.7	2.0	6.3	-2.1	1.2
GDP (annual percent change)	10.9	11.5	5.9	10.6	1.4	3.2
GNP	8.2	10.4	5.0	5.9	4.1	3.0
Net foreign balance	0.6	0.5	0.0	...	...	0.4
Memorandum:						
Current account (as a percent of GDP)	0.4	-0.6	-1.0	-1.2	-0.8	-0.8

Source: IMF staff estimates.

Table 3. Ireland: Summary of Balance of Payments
(In percent of GDP)

	1998	1999	2000	2001	2002 proj.	2003 proj.
Current account balance	0.9	0.4	-0.6	-1.0	-0.8	-1.1
Trade balance	23.0	25.6	26.8	29.1	28.9	30.2
Exports of goods	71.4	72.3	77.2	75.8	75.3	78.0
Imports of goods	-48.3	-46.7	-50.4	-46.8	-46.4	-47.7
Services	-11.7	-11.7	-12.6	-14.2	-14.0	-14.9
Credit	15.2	16.4	17.7	19.6	19.2	18.9
Debit	-26.9	-28.1	-30.3	-33.7	-33.1	-33.9
of which Royalties	-7.0	-7.3	-7.8	-8.2	...	...
Credit	0.2	0.4	0.5	0.3	...	...
Debit	-7.2	-7.8	-8.3	-8.5	...	...
Balance on goods and services	11.4	13.9	14.1	14.9	14.9	15.3
Factor incomes	-12.2	-14.8	-15.7	-16.4	-16.1	-16.6
Credit	23.1	25.8	31.5	27.7	...	...
Debit	-35.3	-40.7	-47.3	-44.1	...	...
Balance on goods, services and income	-0.8	-0.9	-1.6	-1.5	-1.2	-1.4
Current transfers (net)	1.7	1.3	1.0	0.5	0.4	0.3
Capital and financial account	2.6	-1.6	9.9	1.6	...	...
Capital account balance	1.1	0.6	1.2	0.6	...	...
Financial account	1.5	-2.2	8.7	1.0	...	...
Direct investment	5.7	13.1	21.1	4.2	...	...
Portfolio investment	-11.0	-16.1	-5.5	-16.9	...	...
Other investment	9.7	-1.1	-6.8	14.1	...	...
Reserve assets	-3.0	2.0	-0.1	-0.4	...	...
Net errors and omissions	-3.5	1.2	-9.3	-0.6	...	...

Sources: The Central Statistics Office and staff estimates.

Table 4. Ireland: General Government Finances
(In percent of GDP)

	1998	1999	2000	2001	Proj. 2002	Official 2002 1/
Current surplus:	4.0	6.2	7.2	4.8	3.2	3.7
Current revenue, of which	34.6	34.1	33.5	32.3	32.6	33.0
Tax revenue (excluding taxes on capital)	26.7	26.4	25.8	24.3	24.3	24.7
Social security receipts	4.0	4.1	4.2	4.3	4.4	4.4
Miscellaneous	3.9	3.5	3.5	3.6	3.9	3.9
Current expenditure, of which	30.5	27.9	26.4	27.5	29.4	29.3
Interest payments	3.4	2.4	2.1	1.5	1.6	1.6
Goods and services	5.2	5.1	5.0	5.8	6.6	6.5
Compensation of employees	8.7	8.3	7.9	8.2	8.4	8.4
Transfers	12.5	11.5	10.6	11.3	12.1	12.0
Other	0.7	0.7	0.7	0.7	0.7	0.7
Current expenditure, excluding interest and transfers	14.6	14.1	13.6	14.7	15.7	15.6
Capital deficit	1.7	3.9	2.6	3.1	3.3	3.2
Capital receipts (including taxes on capital)	1.9	2.1	2.2	2.2	2.3	2.3
Gross capital formation	2.7	3.0	3.6	4.1	4.3	4.3
Capital transfers 2/	1.0	1.2	1.2	1.1	1.2	1.2
General government balance 2/	2.3	4.1	4.5	1.7	0.0	0.6
Net interest	-2.8	-1.8	-1.6	-1.0	-1.1	-1.1
Primary balance	5.1	4.2	6.1	2.8	1.1	1.7
Memorandum items:						
Structural (as a percent of potential GDP):						
Revenue 3/	36.5	36.2	35.5	34.4	34.4	34.7
Expenditure, of which	34.7	33.4	33.4	34.5	35.4	35.4
unemployment benefits	1.7	1.5	1.3	1.1	1.0	...
Government balance	1.8	2.8	2.1	-0.1	-1.0	-0.7
Primary balance	4.6	4.6	3.7	0.9	0.1	0.4
General government gross debt (as percent of GDP)	55.1	49.6	39.0	36.5	34.9	34.0
Growth in nominal GDP	15.1	15.5	16.2	11.6	7.2	7.9

Sources: Department of Finance and staff estimates.

1/ Projections based on Budget 2002 and revised estimates from March 2002. Structural numbers are based on the staff's methodology and estimates of structural unemployment, unemployment benefits and potential output, but on the authorities' estimates of revenues, expenditures and actual GDP growth.
2/ Excluding a capital transfer related to the repayment of the government's pension liabilities with respect to An Post and Telecom Eireann of 1.8 percent of GDP in 1999 to maintain comparability. If the transfer was included, capital transfers and the overall balance would had been 3.0 and 2.3 percent of GDP in 1999, respectively.
3/ Adjusted for a windfall gain of 0.5 percent of GDP arising from the euro changeover.

Table 5. Ireland: Medium-Term Fiscal Outlook

	2000	2001	2002	2003	2004	2005	2006	2007
	Baseline projection 1/ (As a percent of GDP)							
Total revenue	35.7	34.5	34.9	33.8	33.5	33.6	33.8	33.4
of which:								
Taxes and social security contributions	31.0	29.6	29.7	29.4	29.3	29.5	29.7	29.5
Other	4.7	4.9	5.2	4.4	4.2	4.1	4.0	3.9
Total expenditure	31.1	32.8	34.9	34.5	34.5	34.5	34.5	34.5
of which:								
Primary expenditure	29.1	31.2	33.3	32.8	32.6	32.6	32.6	32.6
of which:								
Gross fixed investment	3.6	4.1	4.3	4.6	4.6	4.6	4.6	4.6
Interest payments	2.1	1.5	1.6	1.7	1.8	1.8	1.9	1.9
Budget balance	4.5	1.7	0.0	-0.7	-1.0	-0.9	-0.7	-1.1
Memorandum:								
Nominal GDP growth in percent	16.2	11.6	7.2	9.0	8.3	7.5	7.1	6.8
Gross debt	39.0	36.5	34.9	33.9	33.8	33.1	32.5	32.4
	Stability Programme December 2001 Update (As a percent of GDP)							
Total revenue	35.7	34.8	35.1	33.7	33.6	...	...	...
Total expenditure	31.1	33.4	34.4	34.2	34.3	...	...	...
of which:								
Collective consumption	4.7	4.5	4.8	4.7	4.7	...	...	...
Social transfers	9.5	9.0	9.5	9.4	9.5	...	...	...
Gross fixed investment	3.7	4.4	4.6	4.6	4.6	...	...	...
Interest payments	2.1	1.6	1.7	1.8	1.7	...	...	...
Other	11.2	13.7	13.9	13.7	13.8	...	...	...
General government balance	4.5	1.4	0.7	-0.5	-0.6	...	...	...
of which due to contingency	...	...	...	-0.8	-1.1	...	...	...
Memorandum:								
Gross debt	38.6	35.8	33.7	33.8	34.1	...	...	...

Sources: Staff estimates and Department of Finance

1/ The baseline assumes that tax revenues will perform according to the latest SP projections in 2003–04, but are adjusted for the difference between the government's and staff's growth assumptions. From 2005 onwards, tax revenues are projected using the government's estimates of tax elasticities. Expenditure estimates for 2002 are based on the latest available official information, whereas projections for 2003–04 assume expenditure to increase at the pace envisaged in the SP (except for interest rate expenditure). From 2004 onwards, primary expenditure-to-GDP ratio is expected to remain constant.

Table 6. Ireland: Indicators of External and Financial Vulnerability
(In percent of GDP, unless otherwise indicated)

	1998	1999	2000	2001	2002 Latest estimate	Date
External indicators						
Exports (annual percent change, value in U.S. dollars)	17.3	12.4	7.6	8.7	3.6	
Imports (annual percent change, value in U.S. dollars)	21.1	9.2	8.5	7.8	3.4	
Terms of trade (goods, annual percent change)	0.3	-2.5	-3.2	4.0	-0.3	
Current account balance 1/	0.9	0.4	-0.6	-1.0	-0.8	
Capital and financial account balance, 1/	2.6	-1.5	9.9	1.6	...	
Of which:						
Inward portfolio investment	49.9	71.5	79.0	88.2	...	
Inward foreign direct investment	9.9	19.5	25.3	9.5	...	
Other investment liabilities (net)	9.7	-1.1	-6.8	14.1	...	
Official reserves (In U.S. dollars, billions)	9.2	5.7	5.4	5.7	5.4	April
Broad money to reserves ratio 2/	7.7	17.0	18.0	19.1	16.6	April
Central bank foreign liabilities (in billions of U.S. dollars) 3/	...	1.5	0.6	0.1	...	
Foreign assets of the financial sector (in billions of U.S. dollars)	137.9	177.4	185.0	218.5	...	
Foreign liabilities of the financial sector (in billions of U.S. dollars)	148.0	187.3	192.8	230.4	...	
Official reserves in months of imports	2.0	1.6	1.7	1.0	...	
Total external debt 4/	12.1	2.8	2.0	1.8	...	
Of which:						
External debt to exports ratio	14.0	3.2	2.1	1.9	...	
External interest payments to exports (in percent)	1.0	0.2	0.2	...	...	
Irish pound against U.S. dollar (period average)	1.43	1.35	1.17	1.14	1.29	June 27
Financial Markets Indicators						
General government debt	55.1	49.6	39.0	36.5	34.9	
Government bond yield (10 years to maturity, end-period)	3.98	5.50	5.02	5.04	5.06	June 27
Government bond yield (real, 10 years to maturity)	1.58	3.90	-0.61	0.16	0.62	May
Annual change in stock market index (in percent, end of period)	23.2	0.4	14.0	-0.3	-16.4	May
Spread of government bond yield with Germany (end of period)	0.10	0.16	0.15	0.10	0.13	June 27
Financial Sector Risk Indicators						
Personal lending as a share of total loans (excluding financial intermediation and government)						
House mortgage finance	40.7	39.7	39.0	38.8	...	
Other housing finance	1.0	0.9	1.0	0.9	...	
Other personal lending	12.4	13.0	12.2	12.5	...	
Commercial property lending as a percent of total loans (excluding financial intermediation) 5/	15.7	18.2	20.5	21.6	...	
Foreign-currency denominated assets (in percent of total assets)	...	41.0	41.5	44.6	...	
Foreign-currency denominated liabilities (in percent of total liabilities)	...	42.8	44.4	47.4	...	
Contingent and off-balance sheet accounts (in percent of total assets) 6/	7.8	8.7	8.9	8.3	...	
Non-performing loans/loans to private sector (in percent) 7/	2.5	1.8	1.9	1.9	...	
Risk-weighted capital/asset ratios of domestic banks (in percent)	11.0	10.4	9.7	11.2	...	
Deposits to M3 ratio 8/	...	1.026	1.034	1.020	...	
Loan-to-deposit ratio vis-à-vis Irish residents 9/	1.143	1.288	1.359	1.437	...	
vis-à-vis total 9/	1.211	1.476	1.549	1.611	...	
Concentration ratios in the banking sector						
No. of banks accounting for 25% of total assets	3	3	3	3	...	
No. of banks accounting for 75% of total assets	23	23	24	21	...	

Sources: Data provided by the authorities, *International Financial Statistics*, Datastream and staff estimates.

1/ Owing to methodological changes, a break in the series occurred between 1997 and 1998.
2/ Break in the series; from 1999 onward data present Irish contribution to euro-area money supply.
3/ Liabilities to non-euro area residents in euro and a foreign currency.
4/ Represents a non-Irish pound debt in 1995-98, and a non-euro debt of the government sector in 1999.
5/ Includes lending for construction, hotels and restaurants, and real estate activities.
6/ Credit equivalent values.
7/ Owing to differences in classification, international comparisons of non-performing loans are indicative only.
8/ Non-government deposits vis-à-vis Irish and non-residents to M3 ratio.
9/ Non-government loans/non-government deposits ratio.

Ireland: Fund Relations
(As of April 30, 2002)

I. **Membership Status**: Joined 8/08/57; Article VIII

II.	**General Resources Account:**	**SDR Million**	**% Quota**
	Quota	838.40	100.00
	Fund holdings of currency	546.85	65.23
	Reserve position in Fund	291.57	34.78
	Financial Transaction Plan transfers (net)	15.00	

III.	**SDR Department:**	**SDR Million**	**% Allocation**
	Net cumulative allocation	87.26	100.00
	Holdings	44.49	50.99

IV. **Outstanding Purchases and Loans:** None

V. **Financial Arrangements:** None

VI. **Projected Obligations to Fund:** None

VII. **Exchange Arrangement**

As of January 1, 1999, the euro became the currency of Ireland and the irrevocably fixed conversion rate between the euro and the Irish pound is 0.787564.

VIII. **Article IV Consultations**

The discussions for the last Article IV consultation were conducted in Dublin during May 8–17, 2001. The staff report (SM/01/139) was considered by the Executive Board on August 1, 2001 (SUR/01/88). Article IV consultations with Ireland are currently on the standard 12-month cycle.

IX. **Technical Assistance:** None

X. **Resident Representative:** None

Ireland: Statistical Issues

Ireland is subject to the statistical requirements and timeliness and reporting standards of the Eurostat and the European Central Bank (ECB). Ireland has cooperated fully with the Fund in providing monetary, international reserves, and selected other financial statistics related to its membership in the European Economic and Monetary Union (EMU). These data are considered comprehensive, reliable, timely, and well documented. Ireland has subscribed to the Fund's Special Data Dissemination Standard (SDDS).

1. Quarterly national accounts on an ESA 1995 basis have been introduced and are currently published within 4 months of its reference period. Real sector data are sometimes published with a lag of 3–6 months, and for some non-SDDS indicators even one year later. Lags are particularly long for unemployment benefits and assistance, employment, earnings, and selected construction indicators. Information on building planning permissions becomes available 12 months after the reference month, while data on earnings (including public sector earnings), employment, and the index of unit wage costs, are available with a 3–7 month lag. Moreover, no overall earnings index exists for Ireland.

2. While the authorities publish Exchequer returns on a quarterly basis, information on the general government balance is available only annually. Furthermore, some discrepancies remain between the general government data reported by the Department of Finance and the Central Statistics Office.

3. The Irish authorities began publication of the current account of the balance of payments within three months of the reference quarter, although the most recent report was published with almost a 5 month lag. The balance of payments data are in line with the *Balance of Payments Manual*, 5th edition (BPM5), although the historical data covers only years starting from 1998. The Irish authorities are planning to compile and publish the data on the country's International Investment Position (IIP) later this year.

Ireland: Core Statistical Indicators
(As of June 27, 2002)

	Exchange Rates	International Reserves	Central Bank Balance Sheet	Reserve/ Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Govern-ment Balance	External (Non-euro denominated) Debt	GDP/ GNP
Date of Latest Observation	6/27/2002	Apr. 2002	Apr. 2002	Apr. 2002	Apr. 2002	6/27/2002	May 2002	Mar. 2002	4th Quarter 2001	2001	2001	4th Quarter 2001
Date Received	6/27/2002	Jun. 2002	Jun. 2002	Jun. 2002	Jun. 2002	6/27/2002	6/14/2002	5/30/2002	4/30/2002	3/19/2002	Apr. 2002	4/30/2002
Frequency of Data	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Quarterly	Annual	Quarterly	Quarterly
Frequency of Reporting	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Quarterly	Annual	Quarterly	Quarterly
Source of Update	Commercial	Central Bank	Central Bank	Central Bank	Central Bank	Commercial	CSO	CSO	CSO	Dept. of Finance	Central Bank	CSO
Monthly Reporting	Internet	Internet	Internet	Internet	Internet	Internet	Internet / Publication	Internet / Publication	Internet / Publication	Internet	Internet/ Publication	Internet/ Publication
Confidentiality	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public
Frequency of Publication	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Quarterly	Biannual	Quarterly	Quarterly

INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL RELATIONS DEPARTMENT

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International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Concludes 2002 Article IV Consultation with Ireland

On July 31, 2002, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Ireland.[1]

Background

Sound economic policies and favorable circumstances supported Ireland's sustained economic expansion over the last decade. Real GDP growth averaged above 7 percent in 1991–2001 reflecting: robust external demand; strong labor supply growth based on a young, educated population and rising female labor force participation; membership in EU and, subsequently, EMU; substantial foreign direct investment, attracted by policies such as a favorable business tax regime and wage moderation; and substantial fiscal consolidation. Unemployment plummeted and per-capita income rose above the EU average. High growth and fiscal consolidation brought the public debt ratio down to 36½ percent of GDP by end-2001.

GDP growth declined in 2001 to almost 6 percent from 11½ percent the year before, reflecting the global slowdown and the Information and Communications Technologies (ICT) shock as well as foot-and-mouth disease-related restrictions. However, the current account remained broadly stable and unemployment only edged up to 4.2 percent (on a claimant count basis) by May 2002. Moreover, after a sharp decline in the third quarter of 2001, output rose again in the fourth quarter. Other—as yet uneven—signs of a recovery have been evident in recent

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

months, including rising manufacturing output, retail sales (excluding automobiles), and consumer and business confidence. The economic slowdown contributed to a reduction in inflation in 2001 and house prices fell for five consecutive months during September-January. However, inflation spiked up again in early 2002, mainly due to indirect tax increases, and house prices rebounded.

The outturn for the general government balance in 2001 of a small surplus (corresponding to broad structural balance) was significantly weaker than budgeted, in marked contrast to previous years. Cyclical effects on revenue of the growth slowdown and temporary factors, such as animal diseases and September 11, contributed to the deterioration as did expenditure overruns and unexpectedly strong revenue effects from past income tax cuts. The resulting fiscal expansion in 2001 is estimated at some 2.2 percent of GDP. The path for medium-term structural balances was also shifted down sharply in the 2002 Stability Programme to a deficit of some 1 percent of GDP in 2003-04 from a surplus of about 4 percent of GDP in 2003 in the previous Programme. This deterioration reflected both higher expenditure growth and lower structural revenues.

The Fund's outlook is for GDP to rise by 3.2 percent in 2002, supported by steady growth in private consumption. Exports are projected to accelerate by mid-year, although the recovery in private investment would take somewhat longer. Given negative short-term real interest rates, monetary conditions are expected to remain easy, even if the ECB tightens monetary policy or the euro appreciates moderately. Nevertheless, price and wage inflation are expected to ease somewhat this year due to ebbing demand pressures. Following a rebound in the latter part of 2002 and 2003, output growth over the medium term is projected to trend down as labor force growth slows reflecting demographics and already low unemployment, and as labor productivity declines with income convergence and the return of foreign direct investment to more normal levels after the bursting of the ICT bubble.

Executive Board Assessment

Directors commended the authorities for Ireland's impressive economic performance, reflected in sustained gains in income and employment over the last decade, and rooted in sound economic policies, a skilled workforce and flexible labor market, and an investor-friendly environment. They observed that the economy appears to have weathered the global slowdown relatively well—partly due to the combination of a weak euro, supportive macroeconomic policies, and a high level of resource utilization prior to the shock.

Directors noted that, notwithstanding the weakness in the domestic technology sector, the economic outlook is broadly favorable, with growth expected to pick up in the second half of 2002, in line with a recovery in world demand. However, they cautioned that there are significant downside risks to the global recovery, and that the continued appreciation of the euro combined with relatively high inflation and labor costs could adversely affect Ireland's competitiveness—particularly in the traditional employment-intensive industries—and the strength of the recovery. These factors could also pose a risk—albeit likely a manageable one—to the financial sector.

Directors expressed concern about the sharp deterioration in the structural fiscal balance in 2001, and the indicators that pointed to an expansionary fiscal stance in 2002, after adjusting for one-time measures and given the risk of revenue underperformance. Directors would have preferred a neutral fiscal stance, that is, an unchanged structural fiscal balance, in 2002, particularly against the background of the easy monetary conditions, but agreed that measures to unwind the stimulus are not advisable at this time in view of the uncertainty of the recovery and the still-sound fiscal position. However, they stressed that public expenditure, particularly wages, should be held to budgeted levels, and that fiscal policy should, at a minimum, be neutral in 2003.

Directors expressed concern over the marked deterioration in the medium-term fiscal outlook, which, unless checked, could risk Ireland's growth prospects. They recommended that the general government position be in structural balance over the medium-term, compared with the projected deficits of about 1 percent of GDP. Such a policy would help sustain investor confidence and provide a margin against possible lower structural revenues or higher fiscal costs. Moreover, in the event of adverse shocks, it would permit the full operation of the automatic stabilizers without breaching the 3 percent deficit limit of the Stability and Growth Pact.

In the discussion on measures to achieve structural balance, Directors—while welcoming the authorities' efforts to develop multi-year departmental spending envelopes—considered that a formal medium-term fiscal framework would serve to improve policy predictability. Such a framework could include an overall fiscal constraint, multi-year spending limits, and safeguards to protect capital spending from budget pressures. In this connection, Directors cautioned against rapidly increasing public spending, and recommended that rigorous value for money criteria, with clearly defined, monitorable outputs, be applied to all spending programs. They welcomed the use of Public Private Partnerships and encouraged further private sector involvement in the provision of public services. Directors emphasized that greater fiscal transparency will be key for the success of a medium-term framework, and some suggested that the authorities undertake a fiscal Report on Standards and Codes.

In considering policies on the revenue side, and, in particular, should a case emerge for additional spending, Directors noted that it would be necessary to find efficient sources of additional tax revenue. There was broad agreement that measures to widen the tax base are preferable to increasing tax rates, and that there is greater scope for user fees. Targeted transfers could offset any adverse effects of these measures on the poor. Directors cautioned against excessive increases in marginal taxes on labor, given possible adverse effects on labor supply and competitiveness.

Directors underscored the risks to the medium-term fiscal position as well as to competitiveness from public sector wage pressures. They urged a cautious approach in phasing in the pay increases agreed under the recent benchmarking agreement and many Directors suggested that any future national wage agreement be divorced from reliance on fiscal concessions—noting that negotiating expenditure commitments could run counter to needed improvements in public expenditure management. Directors noted that continued dialogue among the social partners could be helpful for maintaining social consensus and

establishing wage norms, but underscored that wages should be permitted to reflect market forces, including on the downside and across skill categories.

Directors agreed that strengthening competition through regulatory reform and privatization is key to securing high growth over the medium term. They welcomed the strengthening of the Competition Authority and emphasized the importance of further efforts to liberalize regulatory restrictions, limit the influence of vested interests, and reduce anti-competitive practices, including in the professions and the public services.

Directors noted that the capitalization of the banking system appears to provide an adequate cushion against possible risks to asset quality. Nevertheless, they emphasized that supervisory authorities should ensure that capital and provisions remain adequate in the event of a deterioration in unemployment, company finances, or property prices. Close monitoring of systemic risks and the speedy unification of financial sector regulation will also be important. In addition, Directors encouraged the new, single regulatory authority—when it is established—to give priority to strengthening insurance supervision.

Directors commended the progress made in the provision of statistics. They suggested that the priority should now be to further improve the timeliness and coverage of certain data, particularly on earnings, national accounts, and sectoral balance sheets. Directors welcomed the steps being taken by Ireland to curb money laundering and combat the financing of terrorism.

Directors welcomed the increase in the allocation for official development assistance and the authorities' commitment to achieve the U.N. target of 0.7 percent of GNP by 2007.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board. The Staff Report for the 2002 Article IV Consultation with Ireland is also available.

Ireland: Selected Economic Indicators

	1998	**1999**	**2000**	**2001**	**2002** 1/
Real Economy (change in percent)					
Real GDP	8.6	10.9	11.5	5.9	3.2
Real GNP	7.9	8.2	10.4	5.0	3.0
Domestic demand	9.4	7.0	9.2	3.9	2.8
Exports of goods and services	21.4	15.7	17.8	8.4	4.5
Imports of goods and services	25.8	11.9	16.6	7.7	4.0
HICP	2.2	2.5	5.3	4.0	4.4
Unemployment rate (in percent)	7.4	5.6	4.3	3.9	4.5
Public Finances (percent of GDP) 2/					
General government balance	2.3	4.1	4.5	1.7	0.0
Structural balance 3/	1.8	2.8	2.1	-0.1	-1.0
General government debt	55.1	49.6	39.0	36.5	34.9
Money and Credit (end-year, percent change)					
M3E 4/	18.1	...	14.7	17.2	12.6
Private sector credit	22.6	33.5	20.6	16.5	12.2
Interest rates (year average)					
Three-month 5/	5.4	2.9	4.4	4.2	3.4
10-year government bond yield 5/	4.7	4.8	5.4	4.9	5.2
Balance of Payments (percent of GDP)					
Trade balance (goods and services)	11.4	13.9	14.1	14.9	14.9
Current account	0.9	0.4	-0.6	-1.0	-0.8
Reserves (gold valued at SDR 35 per ounce end of period, in billions of SDRs)	6.7	3.9	4.1	4.2	…
Exchange Rate					
Exchange rate regime		Member of euro area			
Present rate (June 27, 2002)		US$ per euro 0.9873			
Nominal effective rate (1995=100) 6/	97.3	94.0	88.3	89.2	88.9
Real effective rate (1996=100, CPI based) 6/	96.8	93.9	90.9	94.3	96.0

Sources: Central Statistics Office; Department of Finance, Datastream and IMF International Financial Statistics

1/ Staff projections, except where noted.
2/ In percent of GDP. In 1999 the overall balance of 4.1 percent does not take account of discharging future pensions liabilities at a cost of 1.8 percent of GDP.
3/ 2001 figure is adjusted for a one-off transfer of 0.5 percent of GDP arising from the euro changeover.
4/ ME3 was discontinued in December 1998 and the methodology for calculation of Ireland's contribution to the Euro area money supply was amended in January 1999.
5/ For 2002, average of the first five months.
6/ End-March 2002.