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Key Points from December 2012 IMF Staff Report on Ireland

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Ireland continues its track record of strong program implementation. All quantitative targets have been met since the program began and the authorities have pursued the structural reform agenda vigorously.

The Outlook and Risks

Our baseline outlook is for a gradual economic recovery, with real GDP growth rising from an estimated 0.5 percent last year to 1.1 and 2.2 percent respectively in 2013 and 2014. This assumes continued progress in resolving the euro are crisis but represents a downward revision by about 0.3 percentage points, mostly owing to weaker trading partner growth.

I would highlight four risks to this baseline:

1) a further weakening in trading partner activity, the sole engine of growth at the moment;

2) a delay in the revival of banks' lending capacity, which is needed to support the recovery;

3) delays in addressing debt overhangs that reduce disposable income and access to credit, and raise concerns about future tax burdens;

4) a larger drag from fiscal consolidation as the impact of consolidation on growth remains uncertain.

If these factors hinder a gradual pickup in growth in coming years, Ireland's debt outlook would be affected significantly. For example, if growth were to stagnate at about one-half percent in coming years the debt ratio would continue to rise rather than peak at 122 percent of GDP this year. Prolonged low growth could lead to new bank capital needs that would increase public debt.

Policy Recommendations

These risks to growth and the debt outlook mean that Ireland's recently regained access to market funding still faces some vulnerabilities. To secure the objective of sustained market access, it is critical that Ireland continue on the path to restore the banking system to health and to put public finances on a sound footing through consistent implementation of its economic program. But it's also important for Europe to deliver on the commitment made to improve the sustainability of the well-performing program that was made on June 29 last year. Together, these joint efforts can much reduce the risk that Ireland would need to continue to rely on official financial assistance after the current EU-IMF program ends in late 2013.

So, on the **domestic side**, we recommend (i) continued financial sector reforms to support the economic recovery, (ii) adhering to the fiscal consolidation path to ensure debt sustainability, and (iii) structural reforms to enhance the economy's capacity to deliver growth and jobs. Let me give just a few examples:

Financial sector

- We welcome the Central Bank's plans to supervise banks' progress in durably resolving and provisioning problem loans. Together with the personal insolvency reforms, this will help address household debt distress and arrest the deterioration in banks' asset quality.
- Efforts to lower banks' funding costs through the orderly withdrawal of the Eligible Liabilities Guarantee scheme and operational restructuring are essential to strengthen lending capacity.

Fiscal sector

- It is welcome that the deficit for 2012 is likely to have been well within the target of 8.6 percent of GDP. This performance will have contributed to the recent success in accessing the international bond market.
- The 2013 budget entails very difficult spending and revenue measures totaling over 2 percent of GDP to reduce the deficit to 7.5 percent of GDP. We consider it a key step along the path to putting Ireland on a sound fiscal position and urge its full implementation.
- At the same time, if revenues were to underperform due to disappointing growth, we recommend avoiding any significant additional consolidation measures in 2013 so as to not jeopardize the recovery. Additional measures can be deferred until 2015 when the fiscal measures planned are smaller. Let me be clear, though, we're not suggesting that the measures in the budget already released should be deferred.

On the **European side**, we see that dealing with the promissory note issue would be useful to address the heavy debt service burden when the sovereign is still in a weak position. Looking further ahead, converting a portion of Ireland's debt to Europe into equity stakes in its banks owned by the ESM could help to break the sovereign-bank loop and would reduce Ireland's debt. Outright monetary transactions would help cement market access against potential new external stresses.

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