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Ireland: 2005 Article IV Consultation—Staff Report; Staff Supplement; 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 2005 Article IV consultation with Ireland, the following documents have been released and are included in this package:

- the staff report for the 2005 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on May 16, 2005, 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 11, 2005. 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 staff supplement of September 30, 2005 updating information on recent developments.

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its October 5, 2005 discussion of the staff report that concluded the Article IV consultation.

The document listed below have been 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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INTERNATIONAL MONETARY FUND

IRELAND

Staff Report for the 2005 Article IV Consultation

Prepared by Staff Representatives for the
2005 Consultation with Ireland

Approved by Alessandro Leipold and Michael Hadjimichael

July 11, 2005

- The Article IV consultation discussions were held in Dublin during May 5–16, 2005. The mission comprised Mr. Morsink (head), Ms. Honjo, Ms. Iakova, and Ms. Moreno Badia (all EUR). The mission met with Finance Minister Cowen, Central Bank Governor Hurley, CEO of the Financial Services Regulatory Authority O'Reilly, other senior government officials, the employers' federation, the trade unions, and members of the financial and academic communities. Messrs. Lynch and O'Loghlin (OED) attended most meetings.

- Ireland has accepted the obligations of Article VIII, Sections 2, 3, and 4, (Appendix I) and has subscribed to the Special Data Dissemination Standard (Appendix II).

- The authorities have agreed to the publication of the staff report.

Contents Page

EXECUTIVE SUMMARY

Background

Economic performance has been impressive, due in significant measure to sound policies. In line with the global cycle, growth picked up strongly in 2004. Rapid employment growth was supported by immigration, so the unemployment rate was roughly unchanged and wage growth remained moderate. House price appreciation has slowed, but house prices are high on various measures. Real effective exchange rate appreciation over the past few years has raised Ireland's cost levels above those of its main trading partners.

Key policy issues

Outlook: The authorities and staff agreed that economic growth is likely to be very strong in the short term. The housing market was regarded as headed for a soft landing, though the risk of a sharp decline was acknowledged. The authorities and staff agreed that a further erosion of external competitiveness would be a concern. The shared view was that the economy is at about full employment, so rapid growth could give rise to overheating, though there are uncertainties about supply potential. The risks to the forecast are balanced.

Fiscal policy: While public finances are strong, the 2005 budget implies sizable fiscal stimulus, which is ill-advised for an economy close to full employment. There was agreement that fiscal tightening would be desirable to dampen aggregate demand in the short term and to build a cushion in the event that downside risks materialize in the medium term. The shared view was that further efforts are needed to improve value for money in the delivery of public services. Views diverged on the extent of institutional innovation needed to enhance the focus on strategic issues in the public debate of fiscal policy.

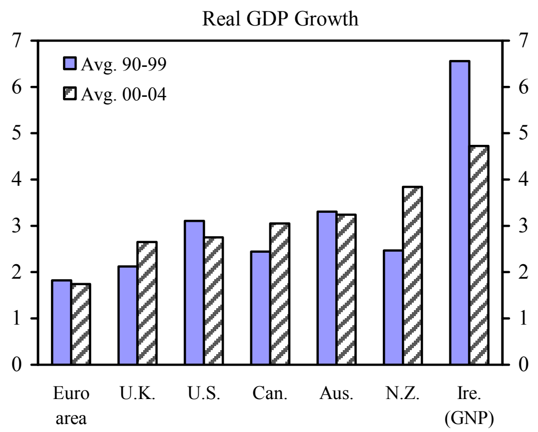
Labor market and wage policy: Labor market flexibility in Ireland is good. However, as labor costs are high, the authorities and staff agreed that wage moderation is needed in both the upcoming national wage agreement and the next public sector benchmarking exercise. Moreover, the methodology and transparency of benchmarking could be improved.

Financial stability: While banking system profitability and capitalization are strong, vulnerabilities exist, so there was agreement that continued efforts are needed to maintain financial stability. The priorities are to further strengthen stress-testing and credit standards, and to prepare an update to the *Financial Stability Report*.

Structural issues: Important progress has been made in preparing for population aging, but there are concerns that households are not saving enough for retirement. The authorities and staff discussed options to raise household saving. While product market reform is well-advanced, there was agreement that better regulation is needed to stimulate competition in some sectors, including banking and insurance, professional services, and retail.

I. BACKGROUND

1. **Economic performance in Ireland was extraordinary during the 1990s and has remained impressive in recent years**. Real GNP grew by 6½ percent per year on average between 1990–99 and by 4¾ percent per year during the 2000–04 cycle.[1] The unemployment rate fell sharply to one of the lowest rates among industrial countries. HICP inflation is now



close to the euro area average. This remarkable performance reflected both good policies and fortunate circumstances. Prudent government spending created the scope for reductions in both public debt and taxes. Social partnership agreements and income tax cuts supported wage moderation, which—along with low corporate tax rates, EU membership, and the global ICT boom—encouraged investment. The EU provided funds for infrastructure investment, and participation in EMU lowered interest rates. Favorable demographics increased the share of the working-age population.

2. **Following a downturn in 2001–02, real GNP growth picked up in 2003–04** (Table 1). Notwithstanding the appreciation of the euro, export growth rebounded in line with the global upturn, and net exports made an increased contribution to growth. Investment accelerated strongly, supported by improving business confidence and low ECB interest rates. Consumption growth was somewhat less buoyant, reflecting contractionary fiscal policy and a slow recovery of consumer confidence from its post-ICT boom decline. All in all, real GNP expanded by 5½ percent in 2004.

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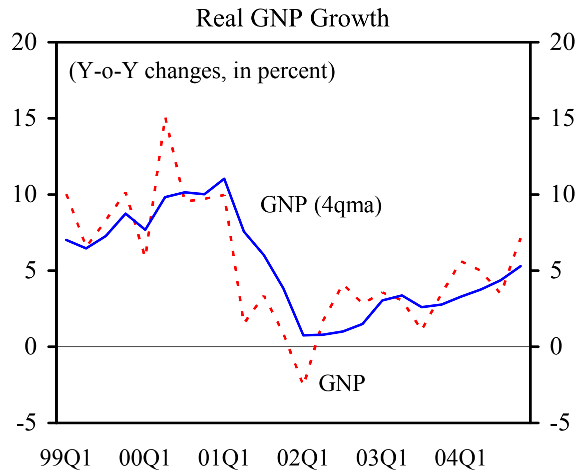
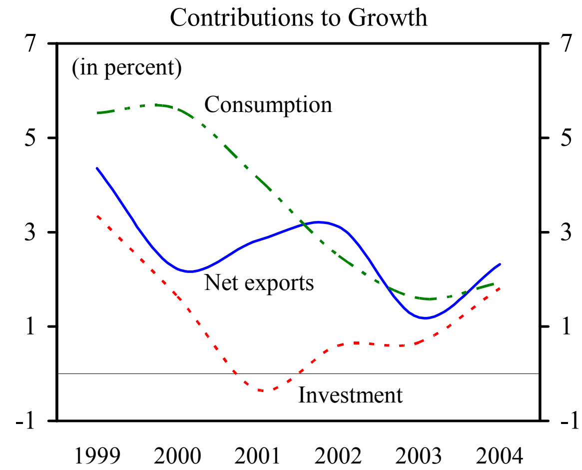
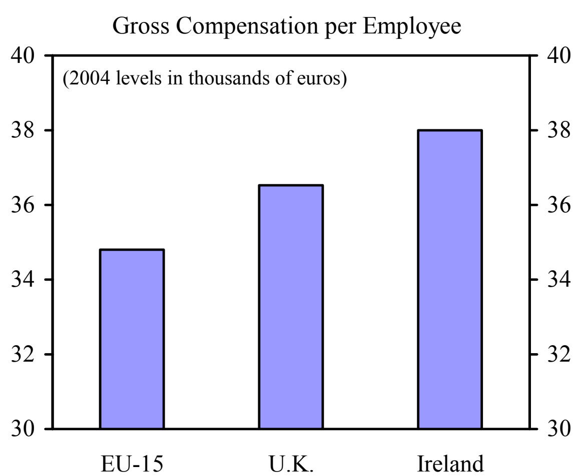
[1] The substantial contribution of multinationals to Irish output and the associated profit repatriation create a large difference between GDP and GNP. GNP excludes payments to foreign factors of production and is a better measure of national income.

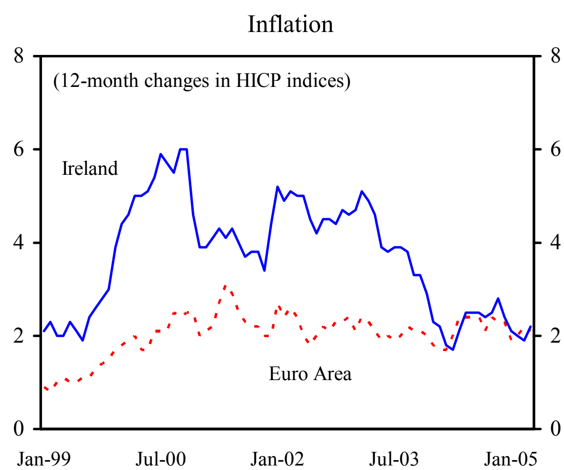




3. **In line with the economic upturn, labor demand strengthened in 2004**. Employment grew by 3 percent, boosted by immigration, especially from new EU member states. As a result, the unemployment rate was roughly unchanged at 4½ percent, and wage growth in the private sector remained moderate. However, with the appreciation of the euro, compensation per employee is now higher in Ireland than in the EU-15 or the U.K. The dampening impact of euro appreciation on consumer prices more than offset upward pressure from higher oil prices, so average HICP inflation fell to 2¼ percent.



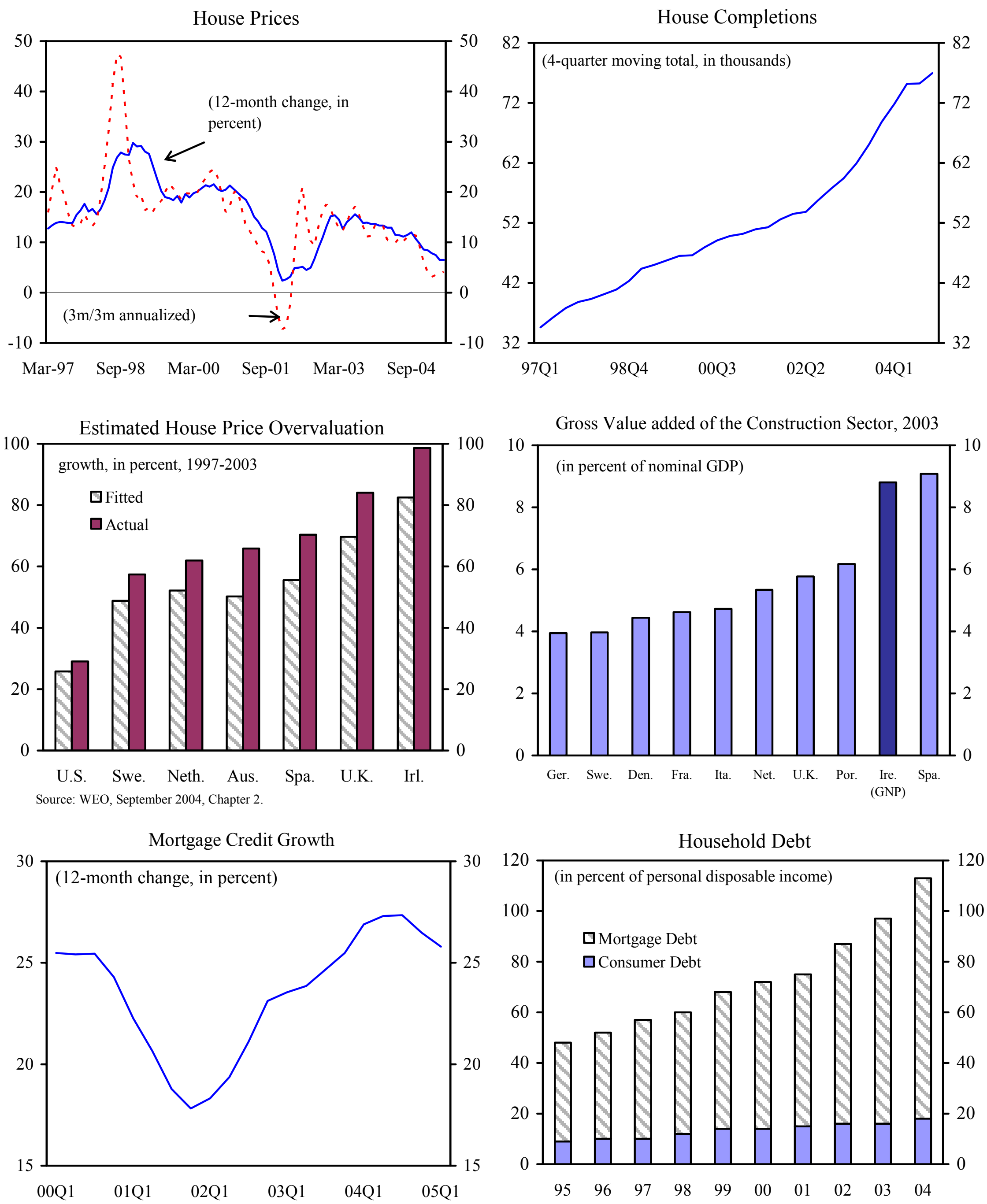
Source: AMECO.



Source: EuroStat.

4. **House price appreciation has slowed, but house prices remain relatively high.** The pace of house price increases has slowed gradually since mid-2003 to 3–5 percent (annual rate) in recent months (Figure 1). In line with easing house price appreciation, the rise in house completions has slowed. However, staff analysis suggests that not all of the increase in house prices over the past several years can be attributed to fundamentals and that the estimated house price overvaluation in Ireland is relatively large compared to other

Figure 1. Ireland: Housing Market Indicators



countries (though—given the inherent uncertainties in these types of calculations—it is difficult to be precise about the degree of overvaluation).[2] The size of the construction sector is correspondingly large, with the ratio of gross value added in construction to GNP surpassed only by Spain in Europe. Despite slowing house price appreciation, mortgage credit growth remains high, and household debt as a share of disposable income continues to rise sharply.

5. **A center coalition government has been in power since June 1997 and was re-elected in May 2002**. Fianna Fail, the senior coalition partner, lost ground at the local and European elections in June 2004. In the subsequent cabinet reshuffle, a new minister for finance was appointed. General elections must take place by mid-2007.

II. Report on the Discussions

6. **Ireland's continuing economic success reinforces the view that good policies have powerful effects**. Indeed, the economy is enviably well positioned to sustain strong growth over the medium term. Nonetheless, the authorities and staff acknowledged that even good policies can be improved, that turbulence from various disturbances—both domestic and external—is always a risk, and that population aging presents challenges. As in recent years (Box 1), the discussions focused on attuning policies to the key challenges to maintaining strong economic performance:

- Given rapid real GNP growth recently, could the continuation of very strong growth give rise to pressures on capacity constraints?
- How can fiscal policy help to relieve potential overheating and build a cushion in the event that downside risks, notably in the housing market, materialize?
- Is competitiveness at risk, and how can the forthcoming national wage agreement and public sector benchmarking exercise help to safeguard it?
- With credit growth—especially to the property sector—remaining high, what further efforts are needed to maintain financial stability?
- From a longer-term perspective, how can households be encouraged to save for retirement, given Ireland's relatively frugal state pension system?

[2] Selected Issues Paper, 2004, *Adjustment in the Housing Market*; and WEO, September 2004, *The Global House Price Boom*.

Box 1. Fund Policy Recommendations and Implementation

Ireland's impressive economic performance since the early 1990s reflects in significant measure the implementation of sound policies consistent with Fund advice. In recent years, the authorities have generally responded appropriately to policy challenges identified in previous consultations (the 2004 PIN is available at http://www.imf.org/external/np/sec/pn/2004/pn04122.htm):

Fiscal policy: The authorities are committed to the SGP, including the medium-term fiscal objective of close to balance or surplus, which the Fund fully supports. However, the fiscal stance has tended to be procyclical, contrary to Fund recommendations. To limit the potential for procyclical stimulus while increasing the predictability, transparency, and efficiency of spending, the Fund has called for a medium-term expenditure framework. Spending envelopes have been introduced for capital spending but not for current spending.

Wage policies: The present three-year national wage agreement contained a considerable degree of wage moderation relative to the past and offered no fiscal concessions, consistent with Fund recommendations. However, progress in limiting public sector wages has been more limited.

Housing market: The authorities' public communication strategy to tame expectations and help induce a soft landing in the housing market, as well as the absence of new fiscal measures to attempt to fine tune the housing market, have been in line with Fund advice.

Financial sector: Financial supervision has been and continues to be strengthened along the lines recommended in the 2000 FSAP and subsequent consultations. An FSAP Update is planned for 2006.

Competition: The pace of regulatory reform has been slower than recommended by the Fund.

A. Outlook: Strong Growth Creates Potential for Wage Pressures

7. **The authorities and the staff agreed that economic growth is likely to be very strong in the short term** (Table 2). Staff project real GNP growth in 2005–06 of about 5 percent, driven by an acceleration in private consumption, in turn supported by strong employment and income growth, fiscal stimulus in 2005, and withdrawals from the Special

Macroeconomic Projections
(Percentage change, unless otherwise indicated)

	2002	2003	2004	2005	2006
Real GNP	1.5	2.8	5.5	5.1	4.9
Real GDP	6.1	3.7	4.9	5.4	5.2
Real domestic demand	3.4	3.3	4.0	4.6	4.9
Private consumption	2.8	2.6	3.2	4.5	5.7
Public consumption	8.6	2.5	2.9	4.5	2.9
Fixed investment	3.0	3.4	9.2	4.3	4.0
Structures	5.3	5.0	7.7	3.5	2.5
Residential investment	5.1	14.4	12.2	2.0	-1.0
Non-residential investment	5.6	-3.6	2.8	5.3	6.5
Equipment	-0.1	1.2	11.3	5.5	6.0
Change in stocks 1/	-0.2	0.4	-0.5	0.1	0.1
Net exports 1/	3.1	1.2	2.3	1.7	1.3
Exports	5.7	-0.8	4.4	5.6	5.2
Imports	3.3	-2.3	2.7	5.0	5.0
Output gap 2/	2.2	-0.8	-0.5	0.0	0.7
Consumer Prices	4.7	4.0	2.3	2.3	2.5
Average unemployment rate	4.4	4.6	4.5	4.2	4.0

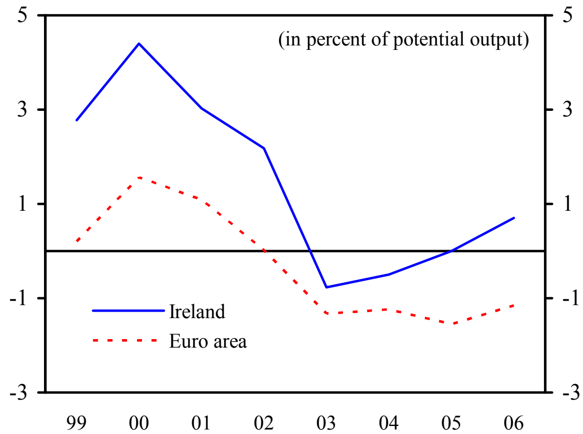
1/ Contributions to growth
2/ In percent of potential output
3/ In percent of GDP

Savings Incentive Accounts (SSIAs) that will begin in mid-2006.[3] Business investment is expected to remain robust, reflecting low interest rates and the continued strength of the global economy. With the gradual cooling of the housing market, residential investment is projected to decline modestly starting next year. Net exports are expected to continue to make significant contribution to growth, but at a declining rate, as domestic demand in Ireland is stronger than that in its main trading partners. Officials at the central bank and the Department of Finance gave broadly similar characterizations of the outlook.

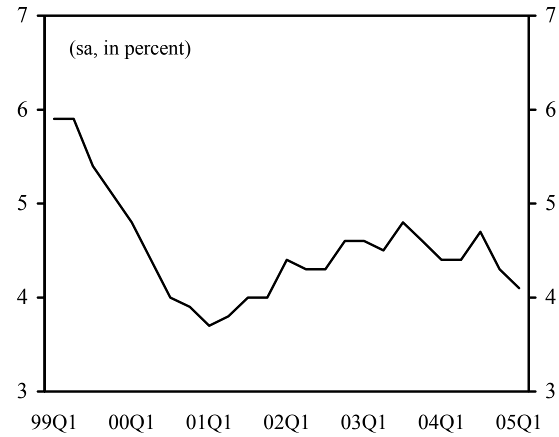
8. **The shared view was that the economy is at about full employment, so continued rapid growth could give rise to overheating.** The unemployment rate in the first quarter was 4¼ percent, not far from its historical low and in the vicinity of most estimates of the NAIRU. While there are uncertainties about the economy's supply potential, including with regard to the role of immigration in relieving incipient labor shortages, there was agreement that projected growth in 2005–06 is somewhat above potential growth, which could give rise to upward pressures on wages and prices. Staff's baseline projection is for a slight increase in HICP inflation to 2½ percent next year.

[3] Individuals receive a 25 percent tax credit on contributions to SSIAs (up to a ceiling). SSIAs were introduced in 2001–02 and must be held for five years to avoid an exit tax.

Output Gap 1/



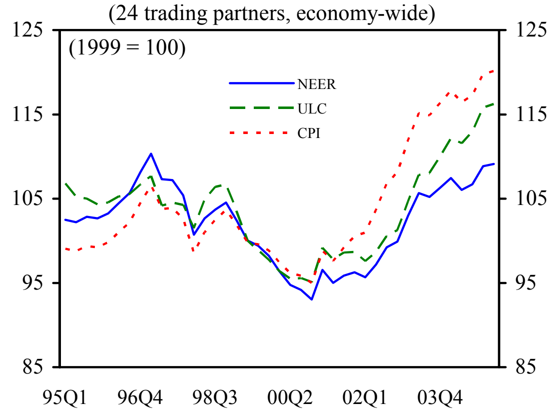
Unemployment Rate



1/ Staff Projections.

9. **The authorities and staff agreed that a further erosion of external competitiveness would be a concern**. The economy-wide ULC- and CPI-based real effective exchange rates have appreciated substantially since 2002, though the pace of appreciation slowed in 2004.[4] Real effective exchange rate appreciation has reflected a combination of nominal effective exchange rate appreciation and relatively high growth of prices and wages.

Nominal and Real Effective Exchange Rates
(24 trading partners, economy-wide)



Source: EuroStat

Ireland's Export Share

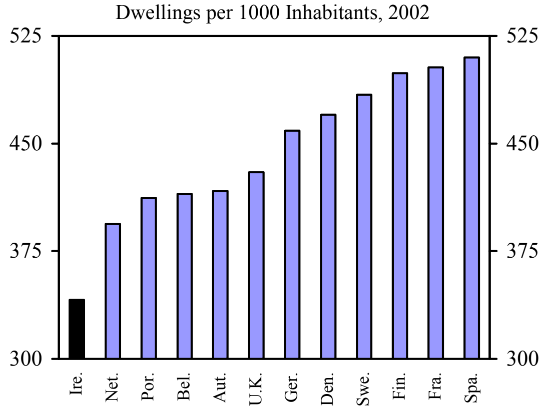
With the strengthening of the euro against the U.S. dollar and—to a lesser extent—sterling, the nominal effective exchange rate has increased by about 14 percent since 2002. At the same time, consumer price and economy-wide ULC inflation rates in excess of partner country rates have raised Ireland's cost levels above those of its main trading partners. Notwithstanding the real effective exchange rate appreciation, the authorities noted that the

[4] A 2004 Selected Issues Paper found that an appropriately weighted ULC-based REER for manufacturing has increased by a similar magnitude as the economy-wide measure.

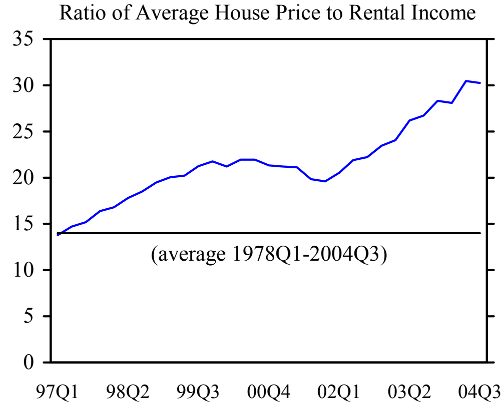
pipeline of inward foreign direct investment remains healthy and prospects for export growth continue to be strong (Table 3). Staff did not see the current level of competitiveness as an immediate, major concern, observing that Ireland's share of industrial country exports of goods and services—after rising during the late 1990s—now appears to have stabilized.

10. **The housing market is widely regarded as headed for a soft landing, though the authorities and staff acknowledged the risk of a sharp decline.** Survey evidence suggests that expectations of house price appreciation have declined in line with the easing of actual house price appreciation. The authorities argued that the underlying demand for housing is relatively strong, noting that the number of dwellings per capita in Ireland is still low compared to other advanced economies in Europe. Nonetheless, the authorities and staff agreed that house prices are relatively high on a variety of measures, including the price-earnings ratio in the housing market, which is still about double its historical average and one-and-a-half times its 2002 level. Although the authorities cited estimates that only about one sixth of the houses built between 2000–04 are second homes or buy-to-let properties, market analysts indicate that a much higher percentage of recent construction falls into these two categories.

Dwellings per 1000 Inhabitants, 2002



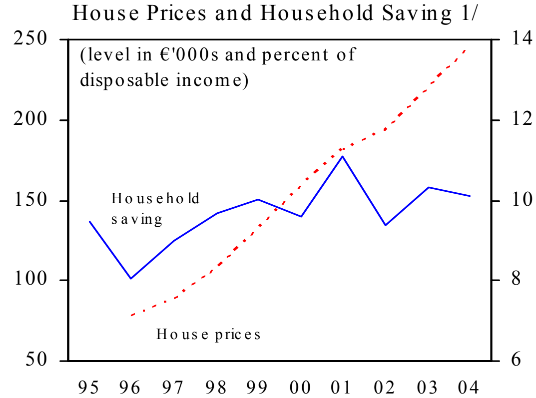
Ratio of Average House Price to Rental Income



Sources: CSO; Department of Environment; 2003 Quarterly National Household Survey; and staff calculations.

11. **The authorities and staff saw the risks to the forecast as being broadly balanced.** Upside risks include stronger-than-expected effects of fiscal stimulus and recovering confidence on domestic demand, especially private consumption and residential investment. On the downside, the key domestic risk is that the housing market could slow more quickly than currently envisaged, with adverse consequences for employment and wealth. However, the house price boom does not appear to have depressed household saving, so price declines would not

House Prices and Household Saving 1/



1/ 2003 and 2004 data are ESRI estimates.

necessarily weaken consumption directly. The main external risks are oil prices and the possibility of a disorderly resolution of global imbalances, which could sharply dampen external demand and inward foreign direct investment.

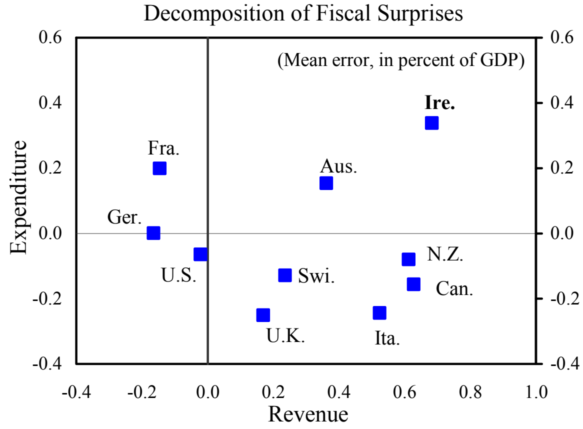
B. Fiscal Policy: Avoiding Procyclicality and Building a Cushion

12. **Ireland's public finances are currently strong, but staff noted that fiscal policy has been procyclical in recent years** (Table 4). Gross public debt is about 30 percent of GDP, among the lowest in the EU; taxes on labor and business income are relatively low; and the general government fiscal position has been either close to balance or in surplus since 1996. However, fiscal policy was expansionary during 2001–02, when economic activity was somewhat higher than potential, and contractionary during 2003–04, when the output gap was negative. In addition, staff analysis finds that between 1991–2003 revenue windfalls, reflecting higher-than-projected economic growth, were usually associated with increased spending (Box 2). The improvement in the general government balance in 2004 (of 1.1 percent of GDP to a surplus of 1.3 percent of GDP) was much stronger than expected, reflecting higher-than-projected growth and one-off factors (receipts from revenue investigations and underspending of the capital budget).

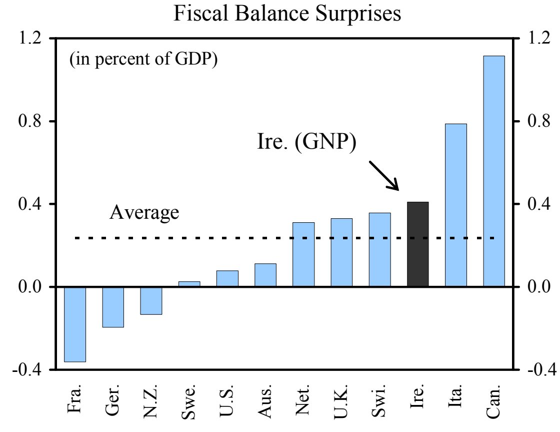
Box 2. Favorable Fiscal Surprises: Luck or Prudence?

Public debt has fallen sharply, reflecting in part favorable fiscal surprises, i.e., outcomes that exceeded budget projections. Staff analysis finds that favorable surprises between 1995–2003 reflected primarily fortunate circumstances (stronger-than-expected economic growth and buoyant asset prices) but prudence also played a role (under-projection of revenue elasticity).[1] Interestingly, revenue overperformance tended to be associated with higher-than-projected expenditure, i.e., some of the good luck was spent (more so than in other industrial countries, see left panel). As a result, the favorable surprises on the overall fiscal balance were not much greater than the average for other industrial countries (see right panel).

Decomposition of Fiscal Surprises



Fiscal Balance Surprises



[1] Selected Issues Paper, Favorable Fiscal Outturns: Is It Just the Luck of the Irish?

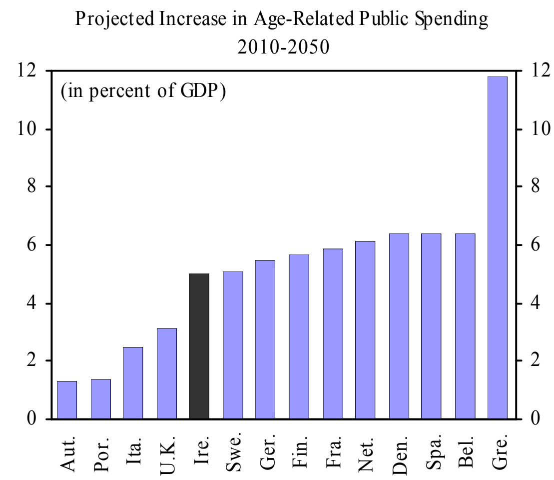
13. **The authorities acknowledged that the budget for 2005 implies a fiscal deterioration** (Table 5). The budget envisages a swing in the overall balance of 1.7 percent of GDP, reflecting mainly higher social welfare payments (0.6 percent of GDP; for old age pensions, child benefit, and unemployment assistance), increased income tax credits and rate bands (0.4 percent of GDP; to ensure that workers on the minimum wage are fully outside the tax net and to partially compensate for the lack of indexation of the bands), and higher public sector pay (0.3 percent of GDP; consistent with previously announced wage increases). Since the budget was released in December, revenues in 2004 and the first few months of 2005 have been stronger than expected. At the same time, the Supreme Court has ruled that the government must reimburse certain nursing home charges received over the past 30 years. Altogether, staff now project that the cyclically adjusted general government balance excluding one-off factors will decline by more than 1 percent of GDP to a deficit of about ½ percent of GDP. Staff observed that the size and timing of the fiscal stimulus are ill-advised for an economy that is close to full employment. While not disputing this point, the authorities noted that the fiscal expansion in 2005 followed two years of contractionary budgets, while also reflecting certain social priorities.

General Government Balances
(In percent of GDP)

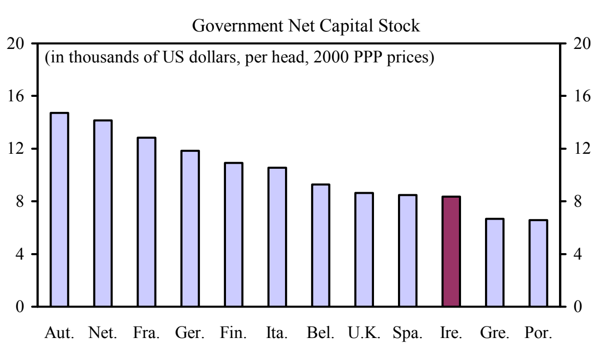
	2002	2003	2004	2005	2006	2007
				Staff projections		
Overall balance	-0.4	0.2	1.3	-1.0	-0.5	-0.5
Cyclically adjusted	-1.2	0.6	1.6	-1.0	-0.7	-0.7
Excluding one-off factors	-1.2	0.2	0.7	-0.5	-0.8	-0.8
o.w. Revenue investigations	0.0	0.0	0.5	0.1	0.0	0.0
Reimbursement of nursing home charges	0.0	0.0	0.0	-0.6	0.0	0.0
Gross public debt	32.7	32.1	29.6	29.6	29.2	29.0

14. **Staff suggested that, given Ireland's cyclically advanced position and accommodative euro area monetary policy, fiscal tightening would be desirable**. The authorities agreed that, during the remainder of 2005, budget execution should remain prudent and any revenue windfalls should be saved, as they had been in 2004. Staff recommended an improvement in the cyclically adjusted fiscal balance of ½ percent of GDP in 2006. While noting strong pressures for higher spending, the authorities said that next year's fiscal position would be in line with their medium-term objective of close to balance or surplus, though preparatory work for the 2006 budget is not yet underway. Staff noted that a balanced budget target in 2006 would be consistent with its call for fiscal tightening. The authorities shared the view that, if aggregate demand were to weaken unexpectedly and abruptly, possibly due to a sharper-than-currently envisaged slowdown in the housing market, automatic stabilizers should be allowed to operate fully.

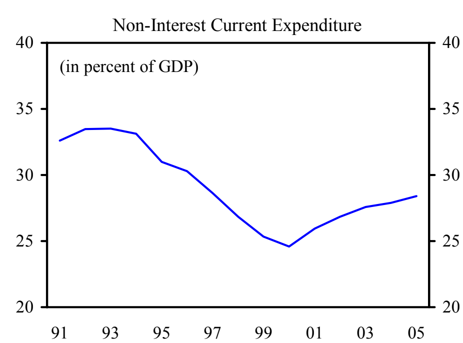
15. **The authorities concurred that fiscal restraint is needed from medium- and long-term perspectives**. They noted that a small open economy like Ireland is subject to global shocks, such as the equity market bust in 2001, which led to a 3½ percent of GDP deterioration in the fiscal balance. They also acknowledged that the cooling housing market would reduce the yield from property-related taxes, though precise quantification is difficult. With age-related spending (on health and pensions) projected to rise by about 5 percentage points of GDP by 2050, the government is setting aside every year 1 percent of GNP in the National Pensions Reserve Fund (NPRF) to prepare for future old-age and civil service pension spending (this does not affect the fiscal balance, but does add to gross debt). Staff welcomed the pre-funding, but noted that it is expected to cover only about one third of the increase in pension spending. The authorities observed that a decline in government spending on infrastructure over the long term would provide room for higher age-related spending. Staff accepted this point, but noted that the scope for reducing infrastructure spending might not be that great (between 2002–04, Ireland spent 4¾ percent of GNP while the industrial country average was 3 percent of GDP). Staff argued that, besides the pre-funding under the NPRF (which currently amounts to about 10 percent of GNP), a further gradual reduction in gross public debt would help prepare for higher age-related spending. In addition, staff suggested that the NPRF avoid potential conflicts of interests in its investment strategy, which could arise in recently authorized (but not yet undertaken) investments in domestic private public partnerships.



16. **Regarding the composition of adjustment, staff suggested that the growth of current spending should be restrained and that the tax base should be broadened.** Given Ireland's relatively low level of public capital, the authorities argued—and staff agreed—that a continued high level of government investment is appropriate. However,



Source: Kamps (2004).



staff noted that non-interest current spending had risen by more than 3 percent of GDP between 2000–04, reflecting across-the-board increases. On the revenue side, there was agreement that Ireland's relatively low levels of business and labor taxes are appropriate, and that the tax net should be broadened. The authorities noted that a review of property-related tax reliefs is currently underway, and staff observed that a useful way to curtail these reliefs would be to establish across-the-board limits on allowances. Staff also suggested preserving the nominal ceiling on mortgage interest tax relief (MITR) and introducing a property tax. The authorities noted that there are no plans at present to raise the MITR ceiling, but that the appetite for a property tax is limited, recalling the short-lived experience with a property tax on high-value homes between 1983 and 1996.

17. **The authorities agreed that further efforts are needed to improve value for money in the delivery of public services.** They noted the introduction of five-year capital envelopes and the recent publication of guidelines for the appraisal and management of capital expenditure proposals. While they acknowledged that multi-year envelopes for current spending would improve predictability and reduce the risk of procyclicality, they felt that the experience with capital envelopes should be assessed first. Staff also suggested extending the fiscal projections (currently only three years) to at least five years. Regarding construction projects, the authorities noted that they intended to increase competition at the tendering stage and improve contracting arrangements. In health services, they pointed to progress in the implementation of the government's reform plan launched in mid-2003, including the establishment of a single national entity to manage health services, the modernization of management planning, and the introduction of a plan indicating services to be delivered and the links between services and staffing.

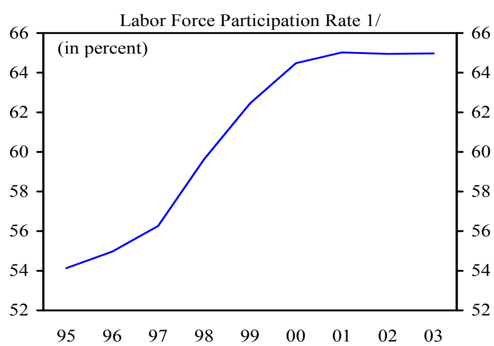
18. **The authorities disagreed with the staff's suggestion to automatically index tax credits and bands and social welfare payments to prices.** Staff argued that, because income tax credits and bands and their interaction with social welfare payments have important effects on work incentives, changes in their real burdens should be explicit policy decisions rather than an untransparent side effect of price inflation. Staff also observed that the current system gives rise to periodic, and thus lumpy, adjustments, which partly underlies the fiscal stimulus in 2005. The authorities responded that the lack of indexation provides important room for maneuver, which can be used for consolidation if necessary. They added that—for consistency—excise rates would also need to be automatically indexed. Staff recognized that the benefits of fiscal neutrality and reduced risk of procyclicality need to be weighed against the loss of fiscal discretion, but observed that most major industrial countries, including Canada, France, the U.K., and the U.S., have adopted automatic indexation to prices.

19. **Given pressures to raise spending and the softening of the SGP, staff saw a role for broader third-party assessment of fiscal policy, but the authorities were not convinced of the merits**. The authorities and staff agreed on the need to deepen public understanding of a number of fiscal issues, including the need to avoid fiscal procyclicality because it tends to exacerbate pressures on capacity when times are good and to deepen economic downturns; the desirability of building a fiscal cushion to prepare for risks over

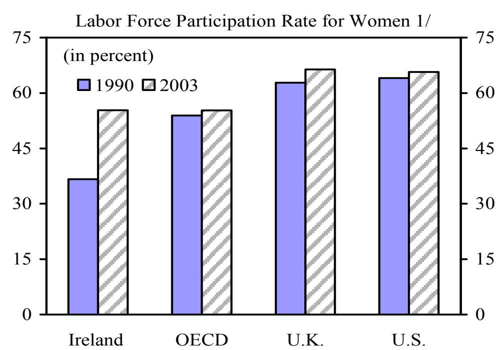
the medium term; and the need to maintain a strong underlying fiscal position so as to help Ireland face rising age-related spending over the long term. In staff's view, broader third-party assessments would enhance the public debate. This could be done by building on existing institutions, such as the National Economic and Social Council (which consists of the social partners and provides the background analysis for the national wage agreements), or by establishing a new body such as a fiscal council. The authorities agreed on the need to improve the focus of the public debate, noting the commitment in the 2005 Budget to expand parliamentary examination of existing budgetary material produced by the government. In their view, however, the key issue is not the lack of third-party assessment, observing that several academics and private analysts make their views known, but rather that the public debate tends to focus on specific budget measures instead of strategic issues. More generally, they doubted whether Ireland's budgetary performance points to the need for major institutional innovations, wondered whether fiscal councils in other countries have always been effective, and were concerned whether, at least in Ireland, a fiscal council would not end up providing a venue for special interests.

C. Labor Market and Wage Policy: Need for Wage Moderation

20. **Labor market flexibility in Ireland is relatively good**. Rapid employment growth since the early 1990s has been driven by rising labor force participation, including



1/ Age 15-64.
Source: OECD.



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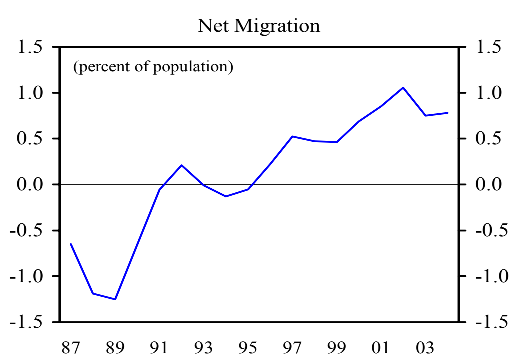
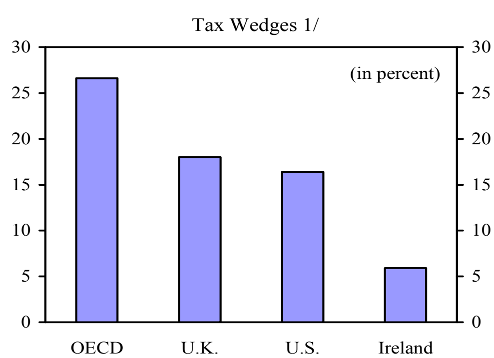
Source: OECD.

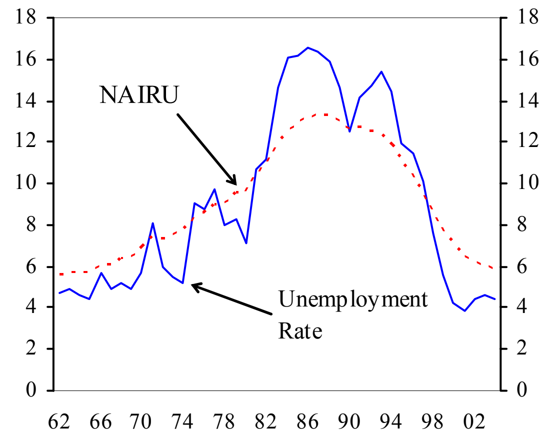




Source: OECD.
1/ Income tax plus employee and employer social security contributions less cash benefits as a percentage of labour costs.

by women, and immigration. The decline in the unemployment rate has reflected the rapid growth of aggregate demand and reforms of the tax and benefit systems (Box 3). The tax wedge is now one of the lowest among industrial countries. The authorities observed that Ireland has allowed immigrants from the new EU member states full access to the labor market, and that immigrants have played a key role in relieving labor shortages.

Box 3. What Explains the Fall in Unemployment?



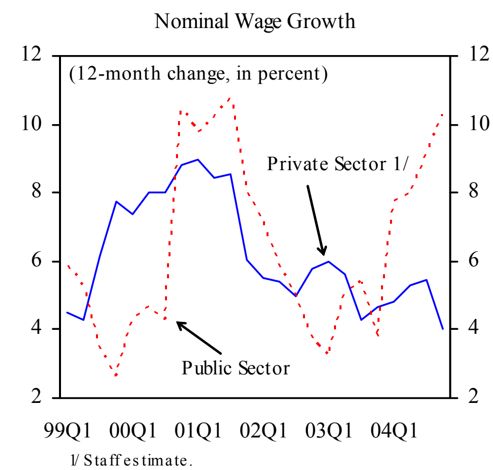
The unemployment rate in Ireland declined from one of the highest to the lowest level in Europe over the past fifteen years. The improvement was broad-based: long- and short-term unemployment rates fell across age groups and education levels. Although estimates of the NAIRU are inherently uncertain, staff analysis finds that more than half of the fall in unemployment is structural.[1] Further analysis shows that the decline in the NAIRU is well explained by changes in labor market policies. Specifically, taxes on labor have been reduced to the lowest level in the OECD and the tax burden on the second earner in married couples has fallen, improving the incentives for work. In addition, the introduction of strict enforcement of eligibility for benefits, the reduction in effective net benefit replacement ratios, the adoption of a system of coordinated wage negotiations, and various active labor market policies have also contributed to the activation of the unemployed.

[1]Selected Issues Paper, *The Evolution of Unemployment in Ireland: The Role of Labor Market Policies.*

21. **However, with labor costs already high relative to euro area partners, the authorities and staff agreed that wage moderation is needed to preserve competitiveness going forward.** National wage agreements and public sector bench-marking exercises play important roles in the wage setting process. Regarding the national wage agreements, social partners (labor unions, employers, and the government) broadly concurred that the agreements have provided a useful vehicle for developing a common view of economic prospects, established sensible guidelines for wage increases while allowing considerable flexibility at the firm level, and preserved peaceful labor relations.

Going forward, the authorities observed that the next wage agreement (to cover 2006–08) would need to take account of lower expected inflation and lower projected productivity growth.

22. **The authorities were satisfied with the first public sector benchmarking exercise, but acknowledged that improvements are needed in the next one.** They noted that the first exercise succeeded in reducing the rigidity of pay relativities across the public sector and enhancing the delivery of public services. Looking ahead to the second exercise, beginning in the second half of 2005 and reporting in 2007, the authorities were of the view that there should be greater focus on recruitment and retention in pay determination, better valuation of pensions, and more emphasis on the flexibility of work practices, especially in education and health. To ensure public accountability, the authorities recognized the importance of making the exercise as transparent as possible, though they pointed to limits on the disclosure of confidential information. Staff noted the risk of spillovers from excessive public sector pay increases to the private sector.

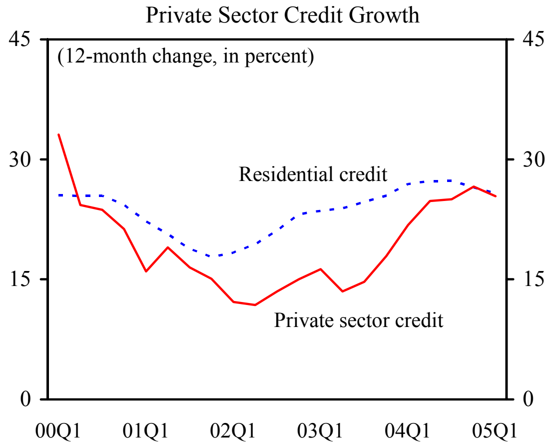


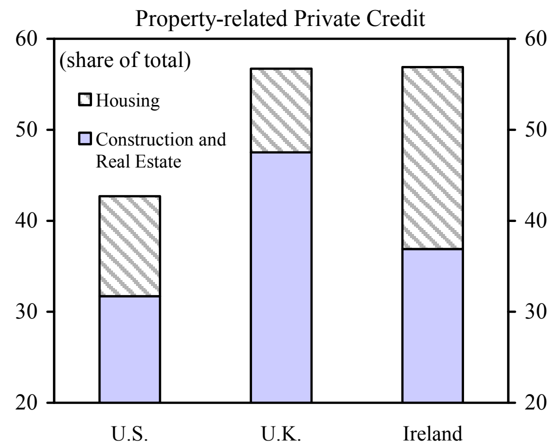
D. Financial Sector: Need for Continued Supervisory Efforts

23. **Banking system profitability and capitalization are strong, but vulnerabilities exist (Table 6)**. Credit growth—while slowing—remains high, property-related lending accounts for more than half of the stock of bank lending, and net interest margins have declined as reliance on more expensive wholesale funding has increased. Household debt has risen sharply and now exceeds 110 percent of disposable income. The authorities argued that efforts to increase awareness of risks—including the central bank's public warnings about the eventual rise in interest rates and the more recent roundtable discussions with heads of financial institutions organized by the central bank and financial regulator—have helped to cool the housing market. They said that a drop in house prices remains a possibility, but the banking system could withstand a considerable fall, as shown by the scenario analysis in the September 2004 *Financial Stability Report*. They added that only one tenth of households have debt service burdens greater than 23 percent of disposable income. The authorities observed that the international diversification of banks' assets is

Financial Indicators

	2001	2002	2003	2004
Bank Return on Equity	16.0	18.0	17.8	...
Risk-weighted capital/asset ratios of domestic banks (in percent)	10.6	12.3	13.9	12.6
Non-performing loans (in percent of total loans)	1.03	0.97	0.93	0.82





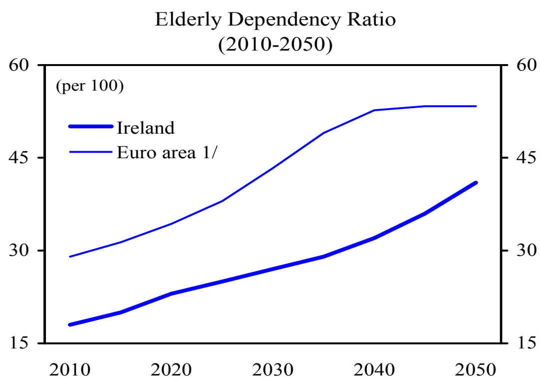
increasing, but staff noted that much of this lending is also property-related. The central bank and financial regulator have established a financial stability committee, which recently conducted a crisis simulation exercise. The authorities noted that asset-covered securities provide relatively inexpensive funding for mortgage lenders.

24. **Looking ahead, the authorities noted that the supervisory priorities are to implement Basel II and further strengthen stress-testing and credit standards.** Basel II requires establishing more risk-based capital requirements. The authorities were satisfied with the latest stress-testing exercise, but are considering further methodological improvements, such as incorporating second-round effects, increasing the variety of shocks, and enhancing the treatment of the realizability of collateral. A recent review of credit standards at major mortgage lenders found that—while standards are generally good—there is a need to tighten lending criteria and establish stricter guidelines for credit officers. In the insurance sector, the authorities are planning to introduce a supervisory regime for reinsurance companies in late 2005 or early 2006, in line with the EU Reinsurance Directive.

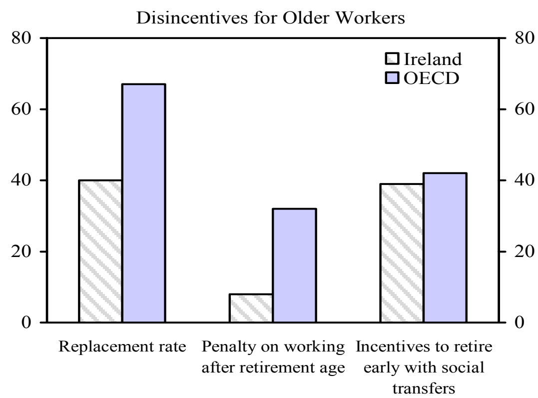
25. **The authorities agreed that there is room to further strengthen competition in the financial sector.** A recent report commissioned by the Competition Authority found obstacles to competition in personal current accounts and lending to small- and medium-sized enterprises. The authorities observed that the double stamp duty charge on switching financial cards has already been removed and that banks have recently agreed to a voluntary code of behavior on switching current accounts. This voluntary code is now being reviewed, as are other measures to increase competition. The authorities are reluctant to eliminate the legal requirement to notify fees on current accounts before they are satisfied that competition has been improved. In the non-life insurance sector, the authorities agreed that greater disclosure of information on claims histories by insurers would facilitate entry and said that they are now addressing practical issues, like the appropriate level of detail and the precise mechanism for disclosure.

E. Population Aging: How to Encourage Saving for Retirement?

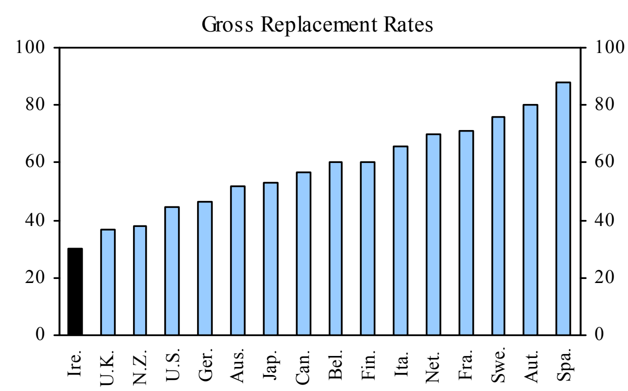
26. **Ireland has already made important progress in preparing for population aging**. The elderly dependency ratio will rise considerably over the coming half century, but the increase is back-loaded compared to the rest of the euro area. Incentives to keep older people in the workforce are relatively strong, so that the effective retirement age is one of the highest among advanced economies. The authorities noted that the pensionable age in the civil service has recently been increased and that provision of an old-age pension bonus for those who work beyond 65 is being considered. Staff suggested phasing out the Retirement Pension, which requires people to effectively stop working in order to be eligible.



Source: U.N. World Population Prospects, The 2002 Revision.
1/ Average of France, Germany, Italy.



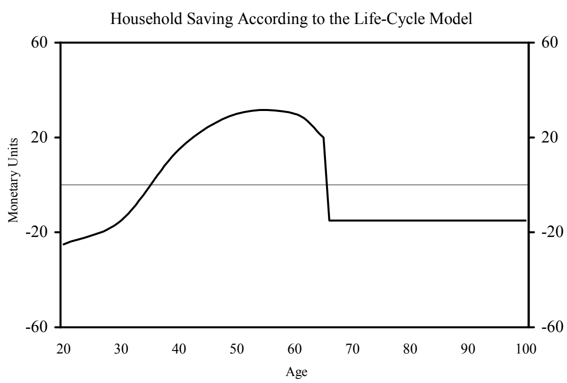
27. **The authorities expressed concern that households are on the whole not saving enough for retirement.** The state-funded old-age pension is relatively frugal compared to other industrial countries and provides a flat share of average earnings, which helps the elderly avoid poverty but does not provide an adequate replacement rate for the majority of workers. Private pensions cover only about half of those at work and many—especially defined-contribution schemes—provide only low replacement rates. Despite media campaigns to promote pension awareness and action, the authorities said that the take-up of Personal Retirement Saving Accounts (a tax-favored, flexible vehicle launched in 2002) has been disappointing. Overall, the Pensions Board cited estimates that, based on a desired average replacement rate of 65 percent and a number of other assumptions, the annual saving shortfall is about 5 percent of GNP. The saving shortfall is especially acute in the middle three quintiles of the income distribution. Staff observed that households at the peak of their life-cycle earnings have relatively low saving (Box 4).

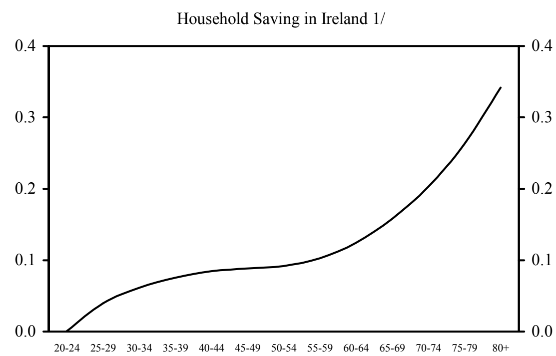


Source: OECD (2003)

Box 4. Who Saves in Ireland?

Given the relatively frugal state pension system in Ireland, an important question is whether households are saving enough for retirement. Using previously untapped microeconomic data from the Household Budget Surveys, staff analysis shows that households at the peak of their life-cycle earnings (aged 45–60) have surprisingly low saving rates compared to other cohorts, though staff find no evidence of a generational saving gap.[1] Moreover, young and poor households appear to save very little. The good news is that booming house prices do not seem to have reduced saving.





1/ Median household saving ratio by age adjusted to the national household saving rate.

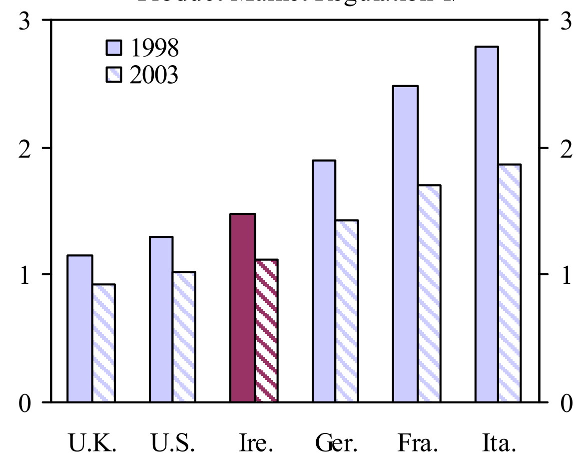
[1]Selected Issues Paper, *Who Saves in Ireland? The Micro Evidence.*

28. **Against this background, a National Pensions Review—due to be completed later this year—is examining policy options to raise household saving.** The authorities observed that there is no magic bullet: raising the state-funded old-age pension would involve considerable additional government spending and, hence, higher taxes; making additional (second pillar) saving mandatory could increase labor costs, imply a government guarantee, and lead to a race to the bottom in occupational pensions; and encouraging voluntary saving through greater tax incentives could be costly in terms of foregone revenue. Indeed, the favorable tax treatment of SSIAs has boosted saving in the form of SSIAs, but the effect on overall saving is not clear. Staff noted that automatic enrolment (with an opt-out clause) can be effective in raising voluntary saving, that the fiscal cost of tax incentives can be reduced by targeting them at lower- and middle-income workers, and that more effort could be devoted to improving financial education.

F. Other Issues

29. **While product market reform is well advanced, the authorities said that better regulation is needed in some sectors to stimulate competition**. Ireland compares well to other industrial countries on indicators of outward orientation, economic regulation, and administrative burden. However, officials at the Competition Authority said that better regulation is needed in retail and professional services. In the retail sector, the ban on below-cost selling is an obstacle to price competition, and entry is limited by planning regulations and the ban on large stores. In the legal profession, the educational monopolies should be abolished and new criteria established for entry by lawyers qualified outside of the EU; similarly, barriers to entry into the pharmacist profession should be removed.

Product Market Regulation 1/



1/ Index - a decline indicates a positive change in the regulatory environment.
Source: OECD.

30. **Statistics are being improved.** National accounts using chain-linked deflators and including financial intermediation services, a quarterly general government balance, and annual sectoral financial accounts will be published later this year. The next steps are to overhaul the earnings data and calculate a production-side estimate of GDP.

III. Staff Appraisal

31. **Economic performance in Ireland has been and continues to be impressive**. Notwithstanding the catch-up in income per capita that has occurred, real GNP growth over the coming five years is projected to remain the highest among industrial countries. The unemployment rate is one of the lowest among industrial countries. Inflation is about 2 percent. This impressive performance is due in significant measure to sound economic policies, including prudent fiscal policy, low taxes on labor and business income, and social pacts that contribute to wage moderation.

32. **With the economy now in the neighborhood of full employment, continued rapid growth could give rise to wage pressures and further erode competitiveness.** The unemployment rate is not far from its historical low. Economic growth is likely to be very strong in the short term, driven by an acceleration in consumption and continued robust business investment, though—with the cooling of the housing market—residential investment is expected to decline modestly starting next year. While there are uncertainties

about the economy's supply potential, the rapid growth of aggregate demand could give rise to upward pressures on wages, which would undermine external competitiveness. The housing market is likely headed for a soft landing, but there is a risk of a sharp decline.

33. **The key priorities for fiscal policy are to help relieve potential overheating and to build a cushion in the event that downside risks materialize.** Public debt is low and fiscal positions have been generally prudent, but the 2005 budget is imparting considerable fiscal stimulus, which is adding to pressures on capacity constraints. Given that interest rates are set for the euro area as a whole and Ireland is relatively cyclically advanced, fiscal policy should help to forestall wage pressures. In the remainder of 2005, budget execution needs to remain prudent and any revenue windfalls should be fully saved; in 2006, underlying fiscal adjustment of ½ percent of GDP would be desirable. Fiscal restraint is also necessary from medium- and long-term perspectives. It is important to build a fiscal cushion when times are good, such as now, to be prepared in the event that downside risks materialize. If aggregate demand weakens unexpectedly and abruptly, automatic stabilizers should be allowed to operate fully and specific measures to prop up the housing market should be avoided.

34. **Regarding the composition of adjustment, the growth of current spending should be restrained and the tax base should be broadened.** There is a strong case for moderating the steep escalation in current spending, so as to limit the risk of inefficiencies. The tax base could usefully be broadened by limiting property-related capital allowances, preserving the nominal ceiling on mortgage interest tax relief, and introducing a property tax.

35. **Against the backdrop of spending restraint, further efforts are needed to improve value for money in the delivery of public services.** Five-year envelopes could be introduced for current spending and fiscal projections could be extended to five years. Government procurement practices could be improved further, and a focus on quantified performance targets in all areas of public services could help motivate efficiency gains. Separately, to improve fiscal neutrality and reduce the risk of procyclicality, it could be desirable to introduce automatic indexation of tax credits, bands and excise duties, and social welfare payments to developments in consumer prices.

36. **Development of mechanisms that build public awareness and understanding of the fiscal issues facing Ireland would be useful.** While the conduct of the fiscal policy in Ireland has been laudable over the years, pressures to raise spending are longstanding and could increase, and an enhanced public debate could help clarify both short- and longer term constraints and requirements.

37. **With labor costs already high, keeping wage growth in line with productivity growth is essential to maintaining competitiveness.** Given the slowdown in productivity growth and the entrenchment of low and stable inflation, there is a strong case for moderating overall wage increases under both the forthcoming national wage agreement and the next public sector benchmarking exercise. In addition, the wage agreement needs to preserve flexibility, given differential productivity developments across firms. The next

benchmarking exercise should avoid putting upward pressure on wages elsewhere in the economy, continue to promote verifiable modernization in the public sector, and be as transparent as possible.

38. **In the financial sector, continued efforts are needed to maintain financial stability.** While banking system profitability and capitalization are strong, vulnerabilities exist, and the authorities' efforts to increase awareness of risks are thus welcome. Looking ahead, continued supervisory efforts are essential to limit excessive risk-taking by lenders and borrowers: stress-testing could be enhanced and conducted more frequently, credit standards could be strengthened, and it is understood that an interim update on financial stability issues to complement the *Financial Stability Report i*s currently being planned.

39. **Given concerns that households are on the whole not saving enough for retirement, the authorities' further consideration of policy responses is welcome.** Beyond encouraging longer active participation in the labor force, the appropriate role of government in addressing inadequate household saving depends crucially on the tradeoff between the risk of forcing some people to save more than they wish and the risk of some people not saving enough and falling back on the government in the future. In general terms, the solution should be clearly sustainable over the long run and provide the right incentives to work and save.

40. **Strengthening competition in the domestic economy is crucial to maintaining strong productivity growth and external competitiveness.** In the banking system, codes of conduct to promote competition could usefully be extended, with the eventual objective of removing the regulation of certain fees. In the non-life insurance sector, greater disclosure of aggregate information on claims histories would be desirable. Better regulation is also needed in retail and professional services to stimulate competition and reduce prices.

41. **Timely and reliable statistics are essential to sound economic policymaking.** Work programs to improve earnings data and introduce a production-side estimate of GDP should be expedited.

42. 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)

	2001	2002	2003	2004	Proj. 2005	Proj. 2006
National accounts (constant prices) 1/						
GNP	3.8	1.5	2.8	5.5	5.1	4.9
GDP	6.0	6.1	3.7	4.9	5.4	5.2
Domestic demand	3.8	3.4	3.3	4.0	4.6	4.9
Private consumption	5.5	2.8	2.6	3.2	4.5	5.7
Public consumption	10.9	8.6	2.5	2.9	4.5	2.9
Gross fixed investment	-1.6	3.0	3.4	9.2	4.3	4.0
Net exports (contribution to GDP growth)	2.8	3.1	1.2	2.3	1.7	1.3
Exports of goods and services	8.4	5.7	-0.8	4.4	5.6	5.2
Imports of goods and services	6.7	3.3	-2.3	2.7	5.0	5.0
Prices, wages and employment						
Harmonized Index of Consumer Prices (annual average)	4.0	4.7	4.0	2.3	2.3	2.5
Average hourly earnings , manufacturing	10.3	8.6	4.7	4.8	...	...
Output, manufacturing 2/	10.0	7.6	4.6	0.4	...	...
Unit wage costs (manufacturing) 2/	-2.6	-8.2	-4.1	0.2	...	...
GNP/employment	0.6	-0.3	0.9	2.4	3.0	3.2
Employment	3.1	1.8	1.9	3.0	2.0	1.6
Unemployment rate (in percent)	3.8	4.4	4.6	4.5	4.2	4.0
Money and credit (end-period)						
M3 3/ 4/	17.2	9.3	...	22.5	16.8	...
Private sector credit 4/ 5/	15.1	15.0	17.9	26.6	26.7	...
Financial and asset markets (end-period)						
Three-month treasury bill 6/	3.3	2.9	2.1	2.2	2.2	...
10-year government bond 6/	5.1	4.3	4.3	3.7	3.6	...
ISEQ index 4/	-0.3	-30.0	23.2	26.0	9.6	...
House prices (permanent tsb index/ESRI) 4/	4.4	13.3	13.7	8.6	6.5	...
Public finance (In percent of GDP)						
General government balance 7/	0.9	-0.4	0.2	1.3	-1.0	-0.5
Primary balance 7/	2.4	1.0	1.5	2.5	0.3	0.8
General government debt	35.9	32.7	32.1	29.6	29.6	29.2
External trade and balance of payments						
Balance of goods and services (Percent of GDP)	15.0	16.6	15.4	15.6	15.0	15.1
Current account (Percent of GDP)	-0.6	-1.3	-1.4	-0.4	-1.0	-1.2
Official reserves (In billions of SDRs, end-period.) 4/	4.5	4.0	2.8	1.9	1.7	...
Effective exchange rates (1995=100, annual average)						
Nominal 6/	89.2	90.7	96.7	99.7	99.4	...
Real (CPI based) 6/	94.4	98.9	106.8	110.2	109.6	...
Memorandum items for 2004:						
Area	70.3 thousand square kilometers					
Population (in million)	4.0					
GDP per capita (in SDRs)	31727.9					

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

1/ Based on National Income and Expenditure, compiled in accordance with the new European System of National Accounts (ESA 95).
2/ Underlying productivity growth data may be overstated because of problems related to the measurement of output produced by multi
companies operating in Ireland.
3/ The methodology used to compile M3 has been amended in line with Eurosystem requirements. Therefore, there is a break in the seri
4/ As of April 2005.
5/ Adjusted change, which includes the effects of transactions between credit institutions and non-bank international financial companie
effects arising from exchange rate movements.
6/ As of March 2005.
7/ Excludes allocations for financing of future pensions liabilities and one-off expenditures.

Table 2. Ireland: Contributions to GDP Growth, 2001-06
(In percent) 1/

	2001	2002	2003	2004	Proj. 2005	2006
Domestic demand	3.2	2.9	2.7	3.3	3.7	4.0
Private consumption	2.8	1.4	1.3	1.5	2.1	2.7
Public consumption	1.4	1.1	0.3	0.4	0.6	0.4
Fixed investment	-0.3	0.6	0.7	1.8	0.9	0.8
Structures	0.5	0.6	0.6	0.9	0.4	0.3
Residential investment	0.3	0.3	0.8	0.7	0.1	-0.1
Equipment	-0.9	0.0	0.1	0.9	0.5	0.5
Change in stocks	-0.6	-0.2	0.4	-0.5	0.1	0.1
Net exports	2.8	3.1	1.2	2.3	1.7	1.3
Exports	9.0	6.2	-0.8	4.6	5.9	5.4
Imports	-6.1	-3.1	2.0	-2.3	-4.1	-4.1
Statistical discrepancy	-0.1	0.1	-0.2	-0.7	0.0	0.0
GDP (annual percent change)	6.0	6.1	3.7	4.9	5.4	5.2
GNP (annual percent change)	3.8	1.5	2.8	5.5	5.1	4.9
Memorandum item:						
Current account (as a percent of GDP)	-0.6	-1.3	-1.4	-0.4	-1.0	-1.2

Source: Fund staff estimates.

1/ Rounding may effect totals.

Table 3. Ireland: Summary of Balance of Payments 2001-06

	2001	2002	2003	2004	Proj. 2005	2006
			(In billions of euro)			
Current account balance	-0.6	-1.6	-1.9	-0.6	-1.5	-2.0
Balance of goods and services	17.3	21.2	20.8	22.7	23.8	25.8
Goods balance	30.5	35.4	33.4	31.9	33.5	36.5
Exports of goods	86.7	89.5	79.2	79.4	83.6	89.5
Imports of goods	-56.2	-54.1	-45.8	-47.6	-50.0	-53.1
Services balance	-13.2	-14.3	-12.6	-9.1	-9.7	-10.6
Credit	27.0	30.2	33.6	37.9	38.7	40.2
Debit	-40.1	-44.5	-46.2	-47.0	-48.4	-50.8
Of which: Royalties						
Credit	0.2	0.3	0.2	0.2	...	...
Debit	-10.6	-11.7	-14.3	-14.3	...	...
Income balance	-18.3	-23.5	-23.1	-23.7	-26.2	-28.8
Credit	32.2	28.9	28.5	31.0	...	...
Debit	-50.5	-52.4	-51.6	-54.7	...	...
Current transfers (net)	0.3	0.7	0.4	0.3	0.9	0.9
Capital and financial account balance	0.4	1.1	3.0	4.8	...	...
Capital account balance	0.7	0.5	0.4	0.4	...	...
Financial account	-0.3	0.6	2.6	4.5	...	...
Direct investment	6.2	19.8	20.7	2.1	...	...
Portfolio investment	-25.2	-38.4	-49.1	-20.9	...	...
Other investment	19.0	18.8	29.3	22.0	...	...
Reserve assets	-0.4	0.3	1.8	1.2	...	...
Net errors and omissions	-0.3	-0.5	1.1	4.2	...	...
			(In percent of GDP)			
Memorandum items						
Current account balance	-0.6	-1.3	-1.4	-0.4	-1.0	-1.2
Balance on goods and services	15.0	16.6	15.4	15.6	15.0	15.1
Goods balance	26.4	27.7	24.8	21.8	21.2	21.3
Services balance	-11.4	-11.1	-9.4	-6.2	-6.1	-6.2
Income balance	-15.8	-18.4	-17.1	-16.2	-16.5	-16.8
Current transfers	0.3	0.6	0.3	0.2	0.6	0.6
Capital and financial account balance	0.3	0.9	2.2	3.3	...	...
Of which:						
Direct Investment	5.4	15.5	15.3	1.5	...	...
Portfolio Investment	-21.8	-30.0	-36.4	-14.3	...	...
Other Investment	16.5	14.7	21.7	15.0	...	...

Sources: The Central Statistics Office; and Fund staff estimates.

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

	2000	2001	2002	2003	2004	2005 Proj.
Current balance	8.0	5.3	3.5	3.9	4.6	2.7
Current revenue, *Of which:*	34.6	32.7	31.7	32.8	33.7	33.2
Tax revenue (including taxes on capital)	26.9	25.0	24.1	25.0	25.8	25.4
Social security receipts	4.2	4.3	4.3	4.4	4.5	4.4
Miscellaneous	3.5	3.4	3.4	3.4	3.4	3.3
Current expenditure, *Of which:*	26.6	27.4	28.2	28.9	29.1	30.4
Interest payments	2.0	1.5	1.4	1.3	1.2	1.3
Goods and services	5.2	5.3	5.8	6.1	6.1	6.1
Compensation of employees	8.0	8.5	8.6	8.8	8.7	9.0
Current transfers	10.7	11.3	11.7	11.9	12.2	13.0
Depreciation	0.7	0.8	0.8	0.8	0.9	1.0
Current expenditure, excluding interest	24.6	25.9	26.8	27.6	27.9	29.1
Capital balance	-3.6	-4.4	-3.9	-3.7	-3.3	-3.8
Capital receipts (excluding taxes on capital)	1.1	1.0	1.1	1.1	1.1	1.0
Gross capital formation	3.7	4.3	4.2	3.9	3.6	3.9
Capital transfers	1.1	1.1	0.8	0.9	0.8	0.9
General government balance	4.4	0.9	-0.4	0.2	1.3	-1.0
Primary balance	6.4	2.4	1.0	1.5	2.5	0.3
Memorandum items:						
Structural (as a percent of potential GDP)						
Government balance (including one-off factors)	2.4	-0.5	-1.2	0.6	1.6	-1.0
Revenue 1/	35.6	33.7	32.8	33.9	34.8	34.2
Expenditure	33.2	34.2	34.0	33.3	33.2	35.2
Government balance (excluding one-off factors)	2.4	-0.5	-1.2	0.2	0.7	-0.5
Primary balance	4.4	1.0	0.1	1.9	2.8	0.3
General government gross debt (as percent of GDP)	38.3	35.9	32.7	32.1	29.6	29.6
Growth in nominal GDP	15.2	12.0	10.9	5.3	8.5	8.4

Sources: Department of Finance and Fund staff estimates.

1/ Revenues in 2002 exclude UMTS receipts of 0.2 percent of GDP.

Table 5. Ireland: Medium-Term General Government Finances 1/
(As a percent of GDP)

	2003	2004	2005	2006	2007	2008	2009	2010
				(Staff Projections)				
Total revenue	33.9	34.8	34.2	33.8	33.7	33.7	33.7	33.7
Taxes and social security contributions	29.4	30.3	29.9	29.6	29.6	29.6	29.6	29.6
Other revenue	4.5	4.5	4.3	4.2	4.1	4.1	4.1	4.1
Contingency provision			0	0	0.0	0.0	0.0	0.0
Total expenditure	33.7	33.5	35.2	34.3	34.2	34.2	34.2	34.2
Primary expenditure, of which:	32.4	32.3	33.9	33.0	33.0	33.0	33.0	33.0
Gross fixed investment	3.9	3.6	3.9	3.8	3.8	3.8	3.8	3.8
Government consumption	15.7	15.7	16.1	15.9	15.9	15.9	15.9	15.9
Current transfers	11.9	12.2	13.0	12.3	12.3	12.3	12.3	12.3
Capital transfers	0.9	0.8	0.9	0.9	0.9	0.9	0.9	0.9
Interest payments	1.3	1.2	1.3	1.3	1.2	1.2	1.2	1.2
Contingency provision			0.0	0.0	0.0	0.0	0.0	0.0
Budget balance	0.2	1.3	-1.0	-0.5	-0.5	-0.5	-0.5	-0.5
Contingency provision			0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:								
Nominal GDP growth in percent	5.3	8.5	8.4	8.0	7.4	6.9	6.8	6.7
Gross debt	32.1	29.6	29.6	29.2	29.0	29.0	29.0	29.0
Structural budget balance, including one-offs 2/	0.6	1.6	-1.0	-0.7	-0.7	-0.5	-0.5	-0.5
Structural budget balance, excluding one-offs 2/	0.2	0.7	-0.5	-0.8	-0.8	-0.5	-0.5	-0.5
Output gap	-0.8	-0.5	0.0	0.7	0.4	0.0	0.0	0.0
				(Stability Program December 2004 Update)				
Total revenue	34.4	35.2	34.2	33.8	33.2	...	...	...
Total expenditure	34.3	34.3	35.0	34.5	33.8	...	...	...
Of which:								
Collective consumption	5.6	5.6	5.7	5.6	5.6	...	...	...
Individual consumption	10.3	10.4	10.5	10.4	10.2	...	...	...
Social transfers in kind	9.1	9.2	9.1	8.9	...	...	...	...
Social transfers other than in kind	9.0	9.5	9.4	9.3	9.2	...	...	...
Gross fixed investment	3.9	3.5	3.9	3.9	3.7	...	...	...
Interest payments	1.3	1.2	1.3	1.2	1.3	...	...	...
Subsidies	0.6	0.6	0.6	0.6	0.6	...	...	...
Other	3.7	3.6	3.6	3.4	3.2	...	...	...
General government balance	0.1	0.9	-0.8	-0.6	-0.6	...	...	...
Of which: due to contingency	...	...	...	0.4	0.8	...	...	...
Memorandum items:								
Nominal GDP growth in percent	5.3	8.3	8.5	8.1	8.1	...	...	...
Gross debt	32.1	30.5	30.1	30.1	30.0	...	...	...
Structural budget balance 2/	0.1	1.4	0.0	0.4	0.3	...	...	...
Output gap	-0.1	-1.1	-1.9	-2.4	-2.1	...	...	...

Sources: Fund staff estimates and Department of Finance

1/ Based on current policies. The staff estimates assume that tax revenues will perform according to the latest SP projections in 2006–07, but are adjusted for the difference between the government's and staff's growth assumptions. From 2008 onwards, tax revenues (excluding indirect taxes) are projected using the OECD's estimates of tax elasticities. Expenditure estimates for 2004 are based on the latest available official information, whereas projections for 2005–07 assume expenditure to increase at the pace envisaged in the SP (except for interest rate expenditure). Due to different accounting conventions, the staff's estimates of total revenue and expenditure ratios differ from the Stability Program.

2/ As a percent of potential GDP.

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

	1999	2000	2001	2002	2003	2004
External indicators						
Exports (annual percent change, value in U.S. dollars)	12.2	10.1	9.6	10.8	13.0	14.5
Imports (annual percent change, value in U.S. dollars)	9.3	12.7	7.4	7.6	12.0	13.2
Terms of trade (goods, annual percent change)	-2.5	-3.1	2.0	2.0	-0.5	-3.9
Current account balance	0.6	-0.1	-0.6	-1.3	-1.4	-0.4
Capital and financial account balance,	-1.8	9.3	0.3	0.9	2.2	3.3
Of which:						
Inward portfolio investment	71.2	81.4	86.0	58.3	69.2	74.8
Inward foreign direct investment	19.1	27.1	9.3	24.1	17.7	7.7
Other investment liabilities (net)	-1.1	-8.8	16.5	14.7	21.7	15.0
Total external debt 1/	2.8	2.0	1.8	0.6	0.0	0.0
Of which:						
External debt to exports ratio	4.0	2.6	2.4	0.8	0.0	0.0
External interest payments to exports (in percent)	0.3	0.2	0.1	0.2	0.0	0.0
U.S. dollar per euro (period average)	1.1	0.9	0.9	0.9	1.1	1.2
U.K. £ per euro (period average)	0.7	0.6	0.6	0.6	0.7	0.7
Financial markets indicators						
General government debt	48.7	38.3	35.9	32.7	32.1	29.6
Government bond yield (10-year, end-period)	5.6	5.1	5.1	4.3	4.3	3.7
Spread of government bond yield with Germany (end of period)	0.6	0.2	0.6	0.2	0.3	0.3
Real government bond yield (10-year, period average, based on national CPI)	3.1	-0.1	0.1	0.3	0.6	1.9
Annual change in ISEQ index (in percent, end of period)	0.4	14.1	-0.3	-30.0	23.2	26.0
Personal lending interest rate	10.5	11.8	10.6	10.4	9.9	9.9
Variable mortgage interest rate	4.2	6.0	4.6	4.2	3.5	3.5
Financial sector risk indicators						
Annual credit growth rates (to private sector)	21.3	21.3	15.1	15.0	17.9	26.6
Annual deposit growth rates	8.1	15.6	15.6	9.6	11.9	14.1
Personal lending as a share of total loans	53.7	52.1	52.2	55.3	55.6	55.8
(excluding financial intermediation and government)						
Of which:						
House mortgage finance	39.7	39.0	38.8	42.4	44.4	44.9
Other housing finance	0.9	1.0	0.9	0.8	0.4	0.3
Other personal lending	13.0	12.2	12.5	12.0	10.8	10.6
Annual mortgage credit growth rates	22.4	24.3	17.8	23.1	25.5	26.5
Commercial property lending as a percent of total loans						
(excluding financial intermediation) 2/	12.4	15.0	16.4	17.0	19.7	21.2
Foreign-currency denominated assets (in percent of total assets)	41.0	41.5	44.6	40.1	32.5	29.4
Foreign-currency denominated liabilities (in percent of total liabilities)	42.8	44.4	47.4	42.9	34.2	32.2
Contingent and off-balance sheet accounts (in percent of total assets) 3/	400.5	465.1	591.8	505.2	537.7	662.0
Non-performing loans (in percent of total loans) 4/	1.0	1.0	1.0	1.0	0.9	0.8
Total provisions for loan losses (in percent of total loans)	1.1	1.1	1.1	1.1	0.9	0.7
Risk-weighted capital/asset ratios of domestic banks (in percent)	10.8	10.7	10.6	12.3	13.9	12.6
Bank return on assets	1.3	1.2	0.9	1.0	0.9	...
Bank return on equity	23.0	22.0	16.0	18.0	17.8	...
Liquid assets of all banks to total assets (liquid asset ratio)	32.0	32.0	30.0	30.0	33.6	33.0
Liquid assets of all banks to short-term liabilities (in percent)	39.0	44.0	37.0	34.0	41.2	40.0
Deposits to M3 ratio 5/ 6/	1.0	1.0	1.0	1.0	1.5	1.4
Loan-to-deposit ratio vis-à-vis Irish residents 2/ 7/	1.3	1.4	1.4	1.4	1.5	1.6
vis-à-vis total 2/ 7/	1.5	1.5	1.6	1.5	1.6	1.7
Concentration ratios in the banking sector						
No. of banks accounting for 25 percent of total assets	3.0	3.0	3.0	3.0	2.0	2.0
No. of banks accounting for 75 percent of total assets	23.0	23.0	21.0	19.0	18.0	17.0
Share of state-owned banks in total assets	3.0	2.0	1.0	0.0	0.0	0.0
Share of foreign-owned banks in total assets	37.0	39.0	42.0	29.0	31.0	34.0

Sources: Data provided by the authorities; Central Bank of Ireland; International Financial Statistics; Bloomberg; and Fund staff estimates.

1/ Represents non-euro debt of the government sector.

2/ Includes lending for construction and real estate activities.

3/ Credit equivalent values.

4/ Owing to differences in classification, international comparisons of nonperforming loans are indicative only.

5/ Non-government deposits vis-à-vis Irish and nonresidents to M3 ratio.

6/ The methodology used to compile M3 has been amended in line with Eurosystem requirements. Therefore, there is a break in the series.

7/ Nongovernment loans/nongovernment deposits ratio.

Ireland: Fund Relations
(As of April 30, 2005)

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	578.05	68.95
Reserve position in Fund	260.36	31.05
Holdings Exchange Rate		

III. **SDR Department:**	**SDR Million**	**% Allocation**
Net cumulative allocation	87.26	100.00
Holdings	58.45	66.99

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

V. **Financial Arrangements:** None

VI. **Projected Payments to the Fund**
(SDR Million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2005	2006	2007	2008	2009
Principal					
Charges/Interest	0.53	0.72	0.72	0.73	0.72
Total	0.53	0.72	0.72	0.73	0.72

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. Ireland maintains an exchange system free of restrictions, other than those in accordance with UN Security Council resolutions and EU regulations. Those restrictions have been notified to the Fund under Decision 144—(52/51).

VIII. **Article IV Consultations**
The discussions for the last Article IV consultation were conducted in Dublin during July 8–20, 2004. The staff report (Country Report No. 04/348) was considered by the Executive Board on October 29, 2004 (EBM/04/102). Article IV consultations with Ireland are currently on the standard 12–month cycle.

IX. **Technical Assistance:** None

X. **Resident Representative:** None

Ireland: Statistical Issues

Data provision is adequate for surveillance. Ireland is subject to the statistical requirements and timeliness and reporting standards of Eurostat and the European Central Bank. It has also subscribed to the Fund's Special Data Dissemination Standard (SDDS).

1. The consumer price index is published monthly. The weights of the current index, December 2001=100, are based on the 1999–2000 Household Budget Survey and prices updated to December 2001. The weights are updated every 5 years. National accounts are based on constant 1995 prices, though there are plans to introduce chain-linking in 2005. Quarterly national accounts are currently published within 3 months of the reference period. Data on employment, earnings, unit wage costs, and national income and expenditure are available with a 3–7 month lag, but some non-SDDS series—such as household disposable income—are published with longer lags. There are plans to introduce sectoral balance sheet data in 2005. Ireland does not have an overall earnings index, but there are plans to extend the scope and consistency of earnings data.

2. There are plans to start publishing a quarterly general government balance in 2005.

3. Quarterly balance of payments data are in line with the *Balance of Payments Manual*, 5^{th} edition (BPM5), although the historical data start only in 1998. Some discrepancies exist between exports and imports data from the national accounts and the balance of payments. Data are compiled by the Central Statistics Office and are based on statistical surveys combined with administrative data. These data are closely integrated with the compilation of national accounts. An integrated computer data processing system was introduced in late 2001. The system provides a powerful prepublication analytical tool.

Ireland: Table of Common Indicators Required for Surveillance
(as of June 6, 2005)

	Date of latest observation	Date received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of publication[6]
Exchange Rates	6/6/05	6/6/05	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Apr 2005	5/31/05	M	M	M
Reserve/Base Money	Apr 2005	5/31/05	M	M	M
Broad Money	Apr 2005	5/31/05	M	M	M
Central Bank Balance Sheet	Apr 2005	5/31/05	M	M	M
Consolidated Balance Sheet of the Banking System	Apr 2005	5/31/05	M	M	M
Interest Rates[2]	6/6/05	6/6/05	D	D	D
Consumer Price Index	Apr 2005	5/12/05	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	2004	3/3/2005	A	A	A
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government	May 2005	6/2/2005	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	2005 Q1	5/4/2005	Q	Q	Q
External Current Account Balance	Q4, 2004	3/24/05	Q	Q	Q
Exports and Imports of Goods and Services	Q4, 2004	3/24/05	Q	Q	Q
GDP/GNP	Q4, 2004	3/31/05	Q	Q	Q
Gross External Debt	Q4 2004	3/31/05	Q	Q	Q

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A); Not Available (NA).

INTERNATIONAL MONETARY FUND

IRELAND

Staff Report for the 2005 Article IV Consultation

Supplementary Information

Prepared by the European Department

Approved by Alessandro Leipold and Michael Hadjimichael

September 30, 2005

1. This supplement reports on recent developments since the staff report was issued.[1] These developments support the thrust of the staff appraisal. In particular, with the economy now in the neighborhood of full employment, continued rapid growth of domestic demand could give rise to wage pressures and further erode competitiveness. Against this background, the key policy priorities remain fiscal restraint, to help relieve potential overheating and to build a cushion in the event that downside risks materialize; wage moderation, to keep wage growth in line with productivity growth; and continued efforts to maintain financial stability.

2. **Revisions to national accounts data for 1995–2004 do not alter the general pattern of economic growth in recent years**. The new data incorporate two methodological improvements: chain-linked deflators and a better measure of financial intermediation services. Average annual real GDP and real GNP growth rates over the period as a whole are virtually unchanged, though growth was slightly weaker during the late 1990s boom and slightly stronger during the downturn of 2001–03. Real GDP growth in 2004 was revised down to 4½ percent, reflecting a lower contribution from net exports, and a reduction in net factor income cut real GNP growth to 4 percent.

3. **Domestic demand growth was very strong in the first half of 2005, as anticipated in the staff report**. Private consumption grew by about 5 percent year-on-year, supported by rapid employment and income growth, and machinery and equipment investment increased by over 25 percent, reflecting in part purchases of aircraft. However, net exports subtracted about 2 percentage points from GDP growth, reflecting in part a slowdown in partner-country growth. House price increases continued to slow, consistent with a soft landing for the housing market, though private sector credit growth remained very high. Employment and the labor force grew by about 5 percent year-on-year in the second quarter, reflecting

[1] The attachment contains updated staff report tables and background section of the PIN.

increases in the working age population—due in part to large net immigration—and in labor force participation, and the unemployment rate fell slightly over the year to 4¼ percent. Despite higher oil prices, HICP inflation was steady at about 2 percent, in line with the euro area average.

4. **While the short-term growth forecast has been revised down, the economic outlook remains strong.** The real GNP growth projection for 2005 has been marked down by 0.6 percentage points to 4½ percent, reflecting mainly the soft patch in exports in the first half. Going forward, higher oil prices are expected to dampen household disposable incomes and corporate profitability, though the strength of consumption and business investment in the first half of the year have resulted in an upward revision to domestic demand for the year as a whole. The staff's new forecast is somewhat below the Department of Finance's projection of 5 percent. In 2006, domestic demand is expected to ease slightly, reflecting in part higher oil prices, and the contribution from net exports to rise slightly, as export growth returns to trend.

5. **Recent fiscal developments are consistent with a projected general government deficit of about 1 percent of GDP in 2005.** As expected, revenue has continued to exceed the budget profile, reflecting in particular VAT and excise receipts, stamp duties, and collections from revenue investigations. Though expenditure has been slightly lower than projected, staff assume that it will be in line with the budget for the year as a whole. Staff's projection is similar to the Department of Finance's revised forecast, published in September.

Table 1. Ireland: Selected Economic Indicators
(Annual change unless otherwise stated)

	2001	2002	2003	2004	Proj. 2005	Proj. 2006
National accounts (constant prices) 1/						
GNP	3.9	2.7	5.1	4.0	4.5	4.9
GDP	6.2	6.1	4.4	4.5	4.5	4.9
Domestic demand	3.9	4.3	4.6	4.3	5.7	4.7
Private consumption	5.6	3.5	3.4	3.8	4.8	5.6
Public consumption	10.6	7.4	3.5	2.4	4.1	2.9
Gross fixed investment	-0.2	3.7	5.6	8.0	8.4	3.7
Net exports (contribution to GDP growth)	2.6	2.2	1.7	0.8	-0.3	0.8
Exports of goods and services	9.3	4.0	0.8	7.0	2.5	5.1
Imports of goods and services	7.3	1.8	-1.4	7.6	3.5	5.0
Prices, wages and employment						
Harmonized Index of Consumer Prices (annual average)	4.0	4.7	4.0	2.3	2.3	2.5
Average hourly earnings , manufacturing	10.3	8.6	4.7	4.5	...	...
Output, manufacturing 2/	10.0	7.6	4.6	0.4	...	...
Unit wage costs (manufacturing) 2/	-2.6	-8.2	-4.1	0.2	...	...
GNP/employment	0.8	0.9	3.2	1.0	1.8	3.2
Employment	3.1	1.8	1.9	3.0	2.6	1.7
Unemployment rate (in percent)	3.9	4.4	4.7	4.5	4.2	4.0
Money and credit (end-period)						
M3 3/ 4/	17.2	9.3	...	22.5	17.7	...
Private sector credit 4/ 5/	15.1	15.0	17.9	26.6	26.7	...
Financial and asset markets (end-period)						
Three-month treasury bill 4/	3.3	2.9	2.1	2.2	2.1	...
10-year government bond 4/	5.1	4.3	4.3	3.7	3.2	...
ISEQ index 4/	-0.3	-30.0	23.2	26.0	26.3	...
House prices (permanent tsb index/ESRI) 4/	4.4	13.3	13.7	8.6	6.2	...
Public finance (In percent of GDP)						
General government balance 6/	0.8	-0.4	0.2	1.4	-1.1	-0.7
Primary balance 6/	2.3	0.9	1.4	2.6	0.1	0.6
General government debt	35.4	32.1	31.1	29.0	29.4	29.3
External trade and balance of payments						
Balance of goods and services (Percent of GDP)	14.7	16.6	15.5	14.9	13.5	13.2
Current account (Percent of GDP)	-0.6	-1.0	0.0	-0.8	-1.9	-2.2
Official reserves (In billions of SDRs, end-period.) 4/	4.5	4.0	2.8	1.9	1.8	...
Effective exchange rates (1995=100, annual average)						
Nominal 7/	89.2	90.7	96.7	99.7	96.8	...
Real (CPI based) 7/	94.4	98.9	106.8	110.2	106.8	...
Memorandum items for 2004:						
Area	70.3 thousand square kilometers					
Population (in million)	4.0					
GDP per capita (in SDRs)	31,728					

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

1/ Based on National Income and Expenditure, compiled in accordance with the new European System of National Accounts (ESA 95).
2/ Underlying productivity growth data may be overstated because of problems related to the measurement of output produced by multinational companies operating in Ireland.
3/ The methodology used to compile M3 has been amended in line with Eurosystem requirements. Therefore, there is a break in the series.
4/ As of July 2005.
5/ Adjusted change, which includes the effects of transactions between credit institutions and non-bank international financial companies and valuation effects arising from exchange rate movements.
6/ Excludes allocations for financing of future pensions liabilities and one-off expenditures.
7/ As of June 2005.

Table 2. Ireland: Contributions to GDP Growth, 2001-06
(In percent) 1/

	2001	2002	2003	2004	Proj. 2005	2006
Domestic demand	3.4	3.7	3.9	3.6	4.8	4.0
Private consumption	2.7	1.7	1.6	1.8	2.2	2.6
Public consumption	1.4	1.0	0.5	0.3	0.5	0.4
Fixed investment	-0.1	0.9	1.3	1.8	2.0	0.9
Structures	0.8	0.9	1.3	1.5	0.9	0.2
Residential investment	0.6	0.5	1.3	1.3	0.3	-0.2
Equipment	-0.6	0.1	0.1	0.3	1.1	0.7
Change in stocks	-0.6	0.1	0.5	-0.3	0.0	0.1
Net exports	2.6	2.2	1.7	0.8	-0.3	0.8
Exports	8.0	3.6	0.7	5.9	2.2	4.3
Imports	-5.4	-1.4	1.0	-5.1	-2.4	-3.4
Statistical discrepancy	0.2	0.2	-1.1	0.1	0.0	0.0
GDP (annual percent change)	6.2	6.1	4.4	4.5	4.5	4.9
GNP (annual percent change)	3.9	2.7	5.1	4.0	4.5	4.9
Memorandum item						
Current account (as a percent of GDP)	-0.6	-1.0	0.0	-0.8	-1.9	-2.2

Source: Fund staff estimates.

1/ Rounding may effect totals.

Table 3. Ireland: Summary of Balance of Payments 2001-06

	2001	2002	2003	2004	Proj. 2005	Proj. 2006
			(In billions of euro)			
Current account balance	-0.8	-1.3	0.0	-1.2	-3.1	-3.7
Balance of goods and services	17.2	21.7	21.5	22.1	21.6	22.8
Goods balance	30.5	35.4	32.6	31.8	32.2	34.6
Exports of goods	86.7	89.5	78.3	80.2	85.7	92.1
Imports of goods	-56.2	-54.1	-45.7	-48.4	-53.5	-57.4
Services balance	-13.3	-13.8	-11.1	-9.7	-10.6	-11.8
Credit	28.6	31.6	37.1	42.2	45.1	48.0
Debit	-41.8	-45.4	-48.2	-51.9	-55.7	-59.8
Of which: Royalties						
Credit	0.2	0.3	0.2	0.2	...	...
Debit	-10.6	-11.7	-14.3	-14.3	...	...
Income balance	-18.3	-23.7	-21.9	-23.6	-25.2	-27.1
Credit	32.2	28.8	30.1	33.8	...	...
Debit	-50.5	-52.4	-52.1	-57.4	...	...
Current transfers (net)	0.3	0.7	0.4	0.3	0.6	0.6
Capital and financial account balance	0.4	1.6	-1.3	4.7	...	...
Capital account balance	0.7	0.5	0.1	0.4	...	...
Financial account	-0.3	1.1	-1.4	4.3	...	...
Direct investment	6.2	19.4	15.3	-3.6	...	...
Portfolio investment	-25.2	-38.0	-40.0	-7.0	...	...
Other investment	19.0	19.3	21.6	13.7	...	...
Reserve assets	-0.4	0.3	1.8	1.2	...	...
Net errors and omissions	-0.4	0.3	-1.3	3.5	...	...
			(In percent of GDP)			
Memorandum items						
Current account balance	-0.6	-1.0	0.0	-0.8	-1.9	-2.2
Balance on goods and services	14.7	16.6	15.5	14.9	13.5	13.2
Goods balance	26.0	27.2	23.4	21.4	20.2	20.1
Services balance	-11.3	-10.6	-8.0	-6.5	-6.7	-6.9
Income balance	-15.6	-18.1	-15.8	-15.9	-15.8	-15.8
Current transfers	0.3	0.5	0.3	0.2	0.4	0.4
Capital and financial account balance	0.3	1.2	-0.9	3.2	...	...
Of which:						
Direct Investment	5.3	14.9	11.0	-2.4	...	...
Portfolio Investment	-21.5	-29.1	-28.7	-4.7	...	...
Other Investment	16.3	14.8	15.5	9.2	...	...

Sources: The Central Statistics Office; and Fund staff estimates.

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

	2000	2001	2002	2003	2004	2005 Proj.
Current balance	7.9	5.1	3.4	3.7	4.7	2.8
Current revenue, *of which:*	34.2	32.3	31.1	31.7	33.1	32.9
Tax revenue (including taxes on capital)	26.6	24.6	23.6	24.2	25.4	25.2
Social security receipts	4.2	4.3	4.2	4.2	4.4	4.4
Miscellaneous	3.4	3.4	3.3	3.3	3.3	3.3
Current expenditure, *of which:*	26.3	27.2	27.7	28.0	28.5	30.1
Interest payments	2.0	1.5	1.3	1.2	1.2	1.3
Goods and services	5.1	5.2	5.4	5.3	5.9	5.9
Compensation of employees	7.9	8.4	8.6	9.0	8.7	9.1
Current transfers	10.6	11.3	11.6	11.8	12.0	12.9
Depreciation	0.7	0.7	0.8	0.8	0.8	0.9
Current expenditure, excluding interest	24.3	25.7	26.4	26.8	27.3	28.8
Capital balance	-3.6	-4.4	-3.8	-3.6	-3.2	-3.9
Capital receipts (excluding taxes on capital)	1.1	1.0	1.1	1.1	1.1	1.1
Gross capital formation	3.6	4.2	4.2	3.8	3.6	3.9
Capital transfers	1.1	1.2	0.8	0.9	0.8	1.1
General government balance	4.3	0.8	-0.4	0.2	1.4	-1.1
Primary balance	6.3	2.3	0.9	1.4	2.6	0.1
Memorandum items						
Structural (as a percent of potential GDP)						
Government balance (including one-off factors)	2.6	-0.5	-1.2	0.4	1.7	-1.1
Revenue 1/	35.2	33.2	32.2	32.9	34.3	34.0
Expenditure	32.6	33.7	33.4	32.5	32.6	35.1
Government balance (excluding one-off factors)	2.6	-0.5	-1.2	0.0	0.8	-0.6
Primary balance	4.6	1.0	0.2	1.6	2.9	0.2
General government gross debt (as percent of GDP)	37.8	35.4	32.1	31.1	29.0	29.4
Growth in nominal GDP	15.2	12.2	11.4	6.6	6.8	7.5

Sources: Department of Finance and staff estimates.

1/ Revenues in 2002 exclude UMTS receipts of 0.2 percent of GDP.

Table 5. Ireland: Medium-Term General Government Finances 1/
(As a percent of GDP)

	2003	2004	2005	2006	2007	2008	2009	2010
				(Staff Projections)				
Total revenue	32.9	34.3	34.0	33.6	33.4	33.4	33.4	33.4
Taxes and social security contributions	28.5	29.8	29.6	29.4	29.3	29.3	29.3	29.4
Other revenue	4.4	4.5	4.3	4.2	4.0	4.0	4.0	4.0
Contingency provision			0.0	0.0	0.0	0.0	0.0	0.0
Total expenditure	32.7	32.9	35.1	34.3	34.2	34.2	34.2	34.2
Primary expenditure, of which:	31.5	31.7	33.8	33.0	33.0	33.0	33.0	33.0
Gross fixed investment	3.8	3.6	3.9	3.8	3.8	3.8	3.8	3.8
Government consumption	15.0	15.3	15.9	15.8	15.8	15.8	15.8	15.8
Current transfers	11.8	12.0	12.9	12.3	12.2	12.2	12.2	12.2
Capital transfers	0.9	0.8	1.1	1.1	1.1	1.1	1.1	1.1
Interest payments	1.2	1.2	1.3	1.3	1.2	1.2	1.2	1.2
Budget balance	0.2	1.4	-1.1	-0.7	-0.8	-0.8	-0.8	-0.8
Memorandum items								
Nominal GDP growth in percent	6.6	6.8	7.5	7.7	7.4	7.2	7.0	6.9
Gross debt	31.1	29.0	29.4	29.3	29.4	29.6	29.7	29.9
Structural budget balance, including one-offs 2/	0.4	1.7	-1.1	-0.8	-0.9	-0.8	-0.8	-0.8
Structural budget balance, excluding one-offs 2/	0.0	0.8	-0.6	-0.9	-1.0	-0.8	-0.8	-0.8
Output gap	-0.3	-0.5	0.0	0.4	0.2	0.0	0.0	0.0
			(Stability Program December 2004 Update)					
Total revenue	34.4	35.2	34.2	33.8	33.2	...	...	...
Total expenditure	34.3	34.3	35.0	34.5	33.8	...	...	...
of which:								
Collective consumption	5.6	5.6	5.7	5.6	5.6	...	...	...
Individual consumption	10.3	10.4	10.5	10.4	10.2	...	...	...
Social transfers other than in kind	9.0	9.5	9.4	9.3	9.2	...	...	...
Gross fixed investment	3.9	3.5	3.9	3.9	3.7	...	...	...
Interest payments	1.3	1.2	1.3	1.2	1.3	...	...	...
Subsidies	0.6	0.6	0.6	0.6	0.6	...	...	...
Other	3.7	3.6	3.6	3.4	3.2	...	...	...
General government balance	0.1	0.9	-0.8	-0.6	-0.6	...	...	...
of which due to contingency	...	...		0.4	0.8	...	...	...
Memorandum:								
Nominal GDP growth in percent	5.3	8.3	8.5	8.1	8.1	...	...	...
Gross debt	32.1	30.5	30.1	30.1	30.0	...	...	...
Structural budget balance 2/	0.1	1.4	0.0	0.4	0.3	...	...	...
Output gap	-0.1	-1.1	-1.9	-2.4	-2.1	...	...	...

Sources: Staff estimates and Department of Finance

1/ Based on current policies. The staff estimates assume that tax revenues will perform according to the latest SP projections in 2006–07, but are adjusted for the difference between the government's and staff's growth assumptions. From 2008 onwards, tax revenues (excluding indirect taxes) are projected using the OECD's estimates of tax elasticities. Expenditure estimates for 2005 are based on the latest available official information, whereas projections for 2006–07 assume expenditure to increase at the pace envisaged in the SP (except for interest rate expenditure). Due to different accounting conventions, the staff's estimates of total revenue and expenditure ratios differ from the Stability Programme.
2/ As a percent of potential GDP.

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

	1999	2000	2001	2002	2003	2004
External indicators						
Exports (annual percent change, value in U.S. dollars)	12.5	10.5	10.1	10.5	14.3	16.7
Imports (annual percent change, value in U.S. dollars)	9.7	13.0	7.9	6.7	13.3	17.5
Terms of trade (goods, annual percent change)	-2.5	-3.1	2.0	2.0	-0.5	-1.4
Current account balance	0.2	-0.4	-0.6	-1.0	0.0	-0.8
Capital and financial account balance,	-1.8	9.2	0.3	1.2	-0.9	3.2
Of which:						
Inward portfolio investment	70.3	80.4	84.8	57.6	75.3	85.6
Inward foreign direct investment	18.9	26.8	9.2	23.9	14.5	6.2
Other investment liabilities (net)	-1.1	-8.7	16.3	14.8	15.5	9.2
Total external debt 1/	2.8	2.0	1.8	0.6	0.0	0.0
Of which:						
External debt to exports ratio	4.0	2.6	2.4	0.8	0.0	0.0
External interest payments to exports (in percent)	0.3	0.2	0.1	0.2	0.0	0.0
U.S. dollar per euro (period average)	1.07	0.92	0.89	0.94	1.13	1.24
U.K. £ per euro (period average)	0.66	0.61	0.62	0.63	0.69	0.68
Financial markets indicators						
General government debt	48.1	37.8	35.4	32.1	31.1	29.0
Government bond yield (10-year, end-period)	5.6	5.1	5.1	4.3	4.3	3.7
Spread of government bond yield with Germany (end of period)	0.6	0.2	0.6	0.2	0.3	0.3
Real government bond yield (10-year, period average, based on national CPI)	3.1	-0.1	0.1	0.3	0.6	1.9
Annual change in ISEQ index (in percent, end of period)	0.4	14.1	-0.3	-30.0	23.2	26.0
Personal lending interest rate	10.5	11.8	10.6	10.4	9.9	9.9
Variable mortgage interest rate	4.2	6.0	4.6	4.2	3.5	3.5
Financial sector risk indicators						
Annual credit growth rates (to private sector)	21.3	21.3	15.1	15.0	17.9	26.6
Annual deposit growth rates	8.1	15.6	15.6	9.6	11.9	14.1
Personal lending as a share of total loans	53.7	52.1	52.2	55.3	55.6	55.8
(excluding financial intermediation and government)						
Of which:						
House mortgage finance	39.7	39.0	38.8	42.4	44.4	44.9
Other housing finance	0.9	1.0	0.9	0.8	0.4	0.3
Other personal lending	13.0	12.2	12.5	12.0	10.8	10.6
Annual mortgage credit growth rates	22.4	24.3	17.8	23.1	25.5	26.5
Commercial property lending as a percent of total loans						
(excluding financial intermediation) 2/	12.4	15.0	16.4	17.0	19.7	21.2
Foreign-currency denominated assets (in percent of total assets)	41.0	41.5	44.6	40.1	32.5	29.4
Foreign-currency denominated liabilities (in percent of total liabilities)	42.8	44.4	47.4	42.9	34.2	32.2
Contingent and off-balance sheet accounts (in percent of total assets) 3/	400.5	465.1	591.8	505.2	537.7	662
Non-performing loans (in percent of total loans) 4/	0.98	1.03	1.03	0.97	0.93	0.82
Total provisions for loan losses (in percent of total loans)	1.1	1.1	1.1	1.1	0.9	0.7
Risk-weighted capital/asset ratios of domestic banks (in percent)	10.8	10.7	10.6	12.3	13.9	12.6
Bank return on assets	1.3	1.2	0.9	1.0	0.9	1.0
Bank return on equity	23.0	22.0	16.0	18.0	17.8	20.7
Liquid assets of all banks to total assets (liquid asset ratio)	32.0	32.0	30.0	30.0	33.6	33.0
Liquid assets of all banks to short-term liabilities (in percent)	39.0	44.0	37.0	34.0	41.2	40.0
Deposits to M3 ratio 5/ 6/	1.03	1.03	1.02	1.02	1.46	1.36
Loan-to-deposit ratio vis-à-vis Irish residents 2/ 7/	1.29	1.36	1.44	1.43	1.46	1.61
vis-à-vis total 2/ 7/	1.47	1.54	1.59	1.51	1.56	1.70
Concentration ratios in the banking sector						
No. of banks accounting for 25 percent of total assets	3	3	3	3	2	2
No. of banks accounting for 75 percent of total assets	23	23	21	19	18	17
Share of state-owned banks in total assets	3	2	1	0	0	0
Share of foreign-owned banks in total assets	37	39	42	29	31	34

Sources: Data provided by the authorities; Central Bank of Ireland; International Financial Statistics; Bloomberg; and Fund staff estimates.

1/ Represents non-euro debt of the government sector.

2/ Includes lending for construction and real estate activities.

3/ Credit equivalent values.

4/ Owing to differences in classification, international comparisons of nonperforming loans are indicative only.

5/ Non-government deposits vis-à-vis Irish and nonresidents to M3 ratio.

6/ The methodology used to compile M3 has been amended in line with Eurosystem requirements. Therefore, there is a break in the series.

7/ Nongovernment loans/nongovernment deposits ratio.

INTERNATIONAL MONETARY FUND
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IMF Executive Board Concludes 2005 Article IV Consultation with Ireland

On October 5, 2005, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Ireland.[1]

Background

Macroeconomic performance in Ireland was extraordinary during the 1990s and has remained impressive in recent years, due in significant measure to good policies. Real GNP growth averaged 4½ percent in 2003–04, reflecting strong domestic demand and healthy net exports. Rapid employment growth was supported by sizable immigration. With the appreciation of the euro since 2002, HICP inflation has fallen to about 2¼ percent. House price appreciation has continued to slow gradually, but house prices remain high on various measures.

Ireland's public finances are strong, but fiscal policy has been procyclical in recent years. Gross public debt is about 30 percent of GDP, among the lowest in the EU; taxes on labor and business income are relatively low; and the general government fiscal position has been either close to balance or in surplus since 1996. However, fiscal policy was expansionary during 2001–02, when economic activity was somewhat higher than potential, and contractionary during 2003–04, when the output gap was negative. The 2005 budget implies considerable fiscal stimulus, at a time when the economy is widely regarded as being close to full employment.

Labor market flexibility is Ireland is good, as reflected in rapid employment growth and low unemployment. This is largely due to reforms of the tax and benefit systems, which has produced one of the lowest tax wedges among industrial countries. However, labor costs are

[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.

high compared to euro area partners. National wage agreements and public sector benchmarking exercises play important roles in the wage setting process.

Banking system profitability and capitalization are strong, and nonperforming loans are low. However, vulnerabilities exist: credit growth—while slowing—remains high, property-related lending accounts for more than half of the stock of bank lending, and net interest margins have declined as reliance on more expensive wholesale funding has increased. Household debt has risen sharply and amounted to 120 percent of disposable income at end-2004.

The elderly dependency ratio in Ireland will rise considerably over the coming half century, though the increase is back-loaded compared to the rest of the euro area. Incentives to keep older people in the workforce are relatively strong, so that the effective retirement age is one of the highest among industrial countries. The state-funded old-age pension provides a flat share of average earnings, which helps the elderly avoid poverty but provides only a low replacement rate for the majority of workers.

Executive Board Assessment

The Executive Directors commended Ireland's continued impressive economic performance, the result of sound economic policies, including prudent fiscal policy, low taxes on labor and business income, and wage moderation. Directors welcomed the authorities' intention to keep these policies in place, allowing Ireland to maintain its competitiveness and sustain its remarkable performance going forward.

Directors expected economic growth to be strong in the short term, driven by an acceleration of consumption and continued robust business investment, though—with the gradual cooling of the housing market—residential investment will likely decline modestly starting next year. The main risks to the outlook are a further rise in oil prices, an abrupt slowdown in global growth, and a sharp decline in the housing market. While acknowledging uncertainties about supply potential, Directors viewed the economy as now being close to full employment. With inflation projected to rise next year, rapid growth of aggregate demand could give rise to wage pressures, which would undermine external competitiveness, especially as labor costs are already high.

Directors welcomed Ireland's low level of public debt and generally prudent fiscal policy. However, they noted that the 2005 budget is imparting considerable fiscal stimulus, adding to cyclical pressures. With euro area monetary policy very accommodative from Ireland's perspective, fiscal policy needs to help relieve potential overheating. Directors called for prudent budget execution and saving any revenue windfalls in the remainder of 2005, and for underlying fiscal tightening in 2006, in line with the authorities' medium-term fiscal objective of close to balance or surplus. In addition, Directors underscored the importance of building a fiscal cushion in good times, such as now, in the event that downside risks materialize. If aggregate demand were to weaken abruptly, Directors agreed that automatic stabilizers should be allowed to operate fully and that specific measures to prop up the housing market should be avoided.

Regarding the composition of fiscal adjustment, Directors recommended that the growth of current spending be restrained and that the tax base be broadened. Moderating the steep escalation in current spending would limit the risk of inefficiencies. The tax base could be broadened by limiting property-related capital allowances, preserving the nominal ceiling on mortgage interest tax relief, and introducing a property tax.

Directors supported the authorities' objective of improving value for money in the delivery of public services. They suggested that five-year envelopes could be introduced for current spending, that fiscal projections could be extended to five years, that government procurement practices could be strengthened further, and that a focus on quantified performance targets could help motivate efficiency gains. Separately, Directors noted that—to improve fiscal neutrality and reduce the risk of procyclical fiscal policy—it could be desirable to introduce automatic indexation of tax credits and bands, excise duties, and social welfare payments to developments in consumer prices.

While the conduct of fiscal policy in Ireland has been laudable over the years, Directors shared the authorities' view that it would be useful to deepen public understanding of fiscal issues. As pressures to raise spending are longstanding and could increase, an enhanced public debate could help clarify both short- and longer term constraints and requirements. However, many Directors did not see a case in Ireland's circumstances for the creation of a fiscal council to provide third-party assessments.

Directors commended the openness and flexibility of Ireland's labor market, and the low labor tax wedge, which have enabled Ireland to benefit from enhanced intra-EU labor mobility and contributed to faster growth and low unemployment. They underscored that keeping wages in line with productivity is essential to maintaining competitiveness, noting that wages are high relative to those in the euro area. With the slowdown in productivity growth and the entrenchment of low and stable inflation, Directors recommended that wage increases under the forthcoming national wage agreement and the next public sector benchmarking exercise be moderate. In addition, Directors noted that the wage agreement needs to preserve flexibility, given differential productivity developments across firms, and that the next benchmarking exercise should be as transparent as possible, continue to promote verifiable modernization in the public sector, and avoid putting upward pressure on wages elsewhere in the economy.

While recognizing the banking system's strong profitability and capitalization, Directors noted that vulnerabilities exist and therefore welcomed the authorities' efforts to increase awareness of risks. They highlighted, in particular, the need to monitor carefully trends in the housing market, given the high exposure of banks to this market. Directors underscored that continued supervisory efforts are essential to limit excessive risk-taking by lenders and borrowers: stress-testing could be enhanced and conducted more frequently, credit standards could be strengthened, and interim updates to the *Financial Stability Report* could be prepared. Directors welcomed the FSAP update planned for 2006.

Directors considered Ireland well placed to cope with the fiscal impact of population ageing, given the low debt ratio and the accumulation of reserves in the National Pensions Reserve Fund. Nevertheless, they shared the concern that households are on the whole not saving enough for retirement, and welcomed the authorities' consideration of further policy responses. Directors noted that Ireland's effective retirement age is one of the highest among industrialized countries, and concurred that encouraging longer active participation in the labor force is important. Beyond that, the appropriate role of government in addressing inadequate household saving depends crucially on the tradeoff between the risk of forcing some people to save more than they wish and the risk of some people not saving enough and falling back on the government in the future. In general terms, the solution should be clearly sustainable over the long run and provide the right incentives to work and save.

Directors agreed that strengthening competition in the domestic economy is crucial to maintaining strong productivity growth and external competitiveness. In the banking system, codes of conduct to promote competition could usefully be extended, with the eventual objective of removing the regulation of certain fees. In the non-life insurance sector, greater disclosure of aggregate information on claims histories would be desirable. Better regulation is also needed in retail and professional services to stimulate competition and reduce prices.

Directors encouraged the authorities to continue their efforts to improve the timeliness and reliability of statistics.

Ireland: Selected Economic Indicators

	2001	2002	2003	2004	2005 1/
Real Economy (change in percent)					
Real GDP	6.2	6.1	4.4	4.5	4.5
Real GNP	3.9	2.7	5.1	4.0	4.5
Domestic demand	3.9	4.3	4.6	4.3	5.7
Exports of goods and services	9.3	4.0	0.8	7.0	2.5
Imports of goods and services	7.3	1.8	-1.4	7.6	3.5
HICP	4.0	4.7	4.0	2.3	2.3
Unemployment rate (in percent)	3.9	4.4	4.7	4.5	4.2
Public Finances (percent of GDP)					
General government balance	0.8	-0.4	0.2	1.4	-1.1
Structural balance 2/	-0.5	-1.2	0.4	1.7	-1.1
General government debt	35.4	32.1	31.1	29.0	29.4
Money and Credit (end-period, percent change)					
M3 3/ 4/	17.2	9.3	...	22.5	17.7
Private sector credit 4/ 5/	15.1	15.0	17.9	26.6	26.7
Interest rates (end-period)					
Three-month 4/	3.3	2.9	2.1	2.2	2.1
10-year government bond yield 4/	5.1	4.3	4.3	3.7	3.2
Balance of Payments (percent of GDP)					
Trade balance (goods and services)	14.7	16.6	15.5	14.9	13.5
Current account	-0.6	-1.0	0.0	-0.8	-1.9
Reserves (gold valued at SDR 35 per ounce) end of period, in billions of SDRs) 4/	4.5	4.0	2.8	1.9	1.8
Exchange Rate					
Exchange rate regime			Member of euro area		
Present rate (September 8, 2005)			US$ per euro 1.2418		
Nominal effective rate (1995=100) 6/	89.2	90.7	96.7	99.7	96.8
Real effective rate (1995=100, CPI based) 6/	94.4	98.9	106.8	110.2	106.8

Sources: Central Statistics Office; Department of Finance, Datastream and IMF International Financial Statistics.
1/ Staff projections, except where noted.
2/ In percent of potential GDP.
3/ The methodology used to compile M3 has been amended in line with Eurosystem requirements. Therefore, there is a break in the series.
4/ As of July 2005.
5/ Adjusted change, which includes the effects of transactions between credit institutions and non-bank internatioanl financial companies and valuation effects arising from exchange rate movements.
6/ As of June 2005.