© 2001 International Monetary Fund

August 2001
IMF Country Report No. 01/139

Ireland: 2001 Article IV Consultation—Staff Report and Public Information Notice on the Executive Board Discussion

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2001 Article IV consultation with Ireland, the following documents have been released and are included in this package:

- the staff report for the 2001 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **May 17, 2001** 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, 2001.** 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.

- the Public Information Notice (PIN), which summarizes the **views of the Executive Board as expressed during its August 1, 2001 discussion** of the staff report that concluded the Article IV consultation.

The policy of publication of staff reports and other documents by the IMF 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.

Copies of this report are available to the public from

International Monetary Fund • Publication Services
700 19th Street, N.W. • Washington, D.C. 20431
Telephone: (202) 623 7430 • Telefax: (202) 623 7201
E-mail: publications@imf.org • Internet: http://www.imf.org

Price: $15.00 a copy

International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

IRELAND

Staff Report for the 2001 Article IV Consultation

Prepared by Staff Representatives for the 2001 Consultation with Ireland

Approved by Jacques R. Artus and Martin Fetherston

July 11, 2001

- The Article IV consultation discussions were held in Dublin during May 8-17, 2001.
- The mission met with Mr. McCreevy, Minister of Finance, Mr. O'Connell, Governor of the Central Bank, other senior officials, representatives of the employers' federation, trade unions, and the financial and academic communities.
- The mission comprised Ms. Coorey (Head), Messrs. Hagemann, Soikkeli (EU1) and Gillingham (FAD). Messrs. Bernes and Charleton, Executive Director and Alternate Executive Director, respectively, participated in some of the meetings.
- Ireland has accepted the obligations of Article VIII, Sections 2, 3 and 4, and maintains an exchange system free of restrictions, other than those in accordance with U.N. Security Council resolutions and EU regulations (Appendix II).
- Ireland has subscribed to the Special Data Dissemination Standard (SDDS).
- The minority coalition government of Prime Minister Bertie Ahern has been in power since June 1997. Under Ireland's constitution, the next general election must take place by June, 2002.

Contents | Page

I. Introduction....4

II. Background to the Discussions....5
A. Recent Economic Developments....5
B. Policy Developments....11

III. Policy Discussions....16
A. Economic Outlook and Policies....16
Economic Outlook and Risks....16
Fiscal Policy....19
Financial Sector Supervision....22
B. Framework Issues and Policies....23
National Wage Agreement....23
Deregulation and Privatization....25
Medium-term Fiscal Framework....25
Other Issues....26

IV. Staff Appraisal....27

Text Boxes
1. Wage Inflation and Competitiveness....30
2. Main Conclusions and Recommendations of the FSAP....32

Supplementary Notes
1. Fiscal Policy in Ireland....33
2. Incomes Policies....38

Tables
1. Selected Economic Indicators....41
2. Summary of Balance of Payments....42
3. Labor Force and Employment Growth....7
4. Fiscal Stance, 1998-2001....13
5. General Government Finances....43
6. Stability Program (2001-2003)....44
7. Main Budgetary Measures in 2001....14
8. Comparison of Budget Projections....15
9. Indicators of External and Financial Vulnerability....45

Figures
1. International Comparisons : Real Output....4
2. Consumer Prices: Comparison with Euro Area....4
3. Comparisons of Key Indicators with Other Euro Area Countries....6
4. Contribution to GNP Growth....5

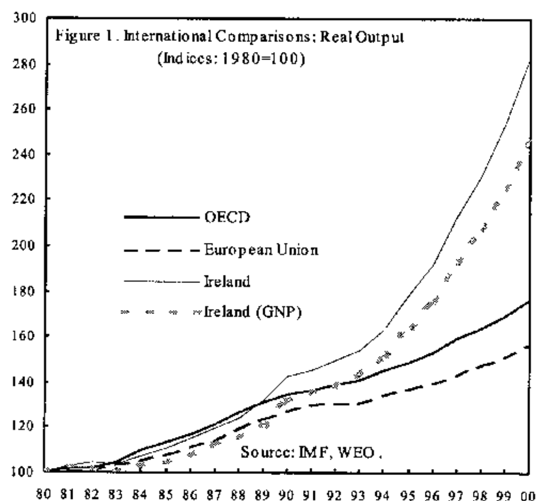
5. Activity Indicators 5
6. Confidence Indicators 7
7. Cross-country Comparisons of Labor Market Trends 8
8. Employment and Unemployment Developments 9
9. Average Weekly Wages 10
10. Consumer Prices: Decomposition 10
11. Real Asset Prices 11
12. Real Monetary Conditions Index: Cross-Country Comparison 11
13. Interest Rate Developments 12
14. Private Sector Credit Growth in Real Terms 13
15. General Government Debt 14
16. Replacement Ratios for Single Person by Gross Annual Income 21
17. Corporate Taxes as a percent of GDP 21

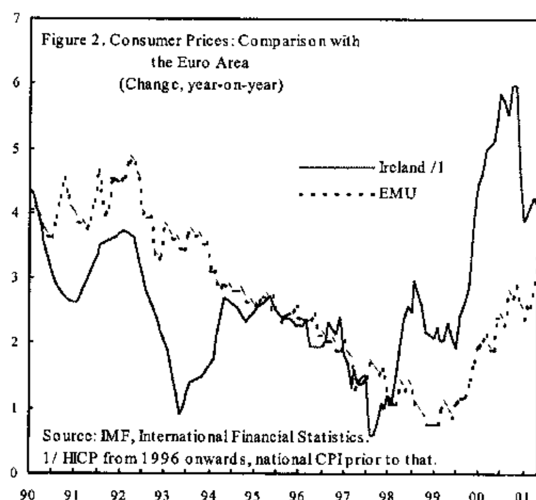
Appendices

I. Basic Data 46
II. Fund Relations 47
III. Statistical Issues 48

I. INTRODUCTION

1. **Ireland's remarkable decade and a half economic expansion gathered steam in recent years.** GDP growth surged 9.7 percent on average during 1995-2000, spurred by Ireland's participation in the European single market and EMU, generally sound macroeconomic policies, strong labor force growth, and a tax and regulatory environment conducive to foreign direct investment. With GNP growth averaging 8.4 percent during the same period, per capita income surpassed the euro area average in 2000, up from about two-thirds the average five years earlier. The high growth rates allowed the government to simultaneously cut taxes and drastically reduce the ratio of public debt to GDP. During 2000, however, signs of potential overheating appeared: inflation accelerated sharply to well above rates in partner countries, asset prices—especially real estate prices—rose rapidly, infrastructure bottlenecks intensified, and support for wage moderation began to wane as labor markets tightened.





2. **At the conclusion of the last Article IV Consultation in August 2000, Executive Directors commended the authorities for sound and consistent macroeconomic and structural policies.** However, they stressed concerns about overheating and called for a tightening of the fiscal stance to help dampen excess demand pressures and moderate inflation. They also noted the desirability of reducing the reliance on wage-tax trade-offs, which tended to impart a procyclical bias to fiscal policy. Directors welcomed Ireland's participation in the Financial Sector Assessment Program (FSAP) and agreed that the overall framework for prudential regulation and supervision was well developed. Noting the risks to the financial sector and macroeconomic stability from rapid lending growth, they encouraged the authorities to monitor the situation closely and to use the full range of prudential tools at their disposal.

3. **Developments since the last consultation have highlighted the need to adapt the policy framework to an environment of full employment.** With both actual and potential GDP growing strongly in 2000, the fiscal surplus exceeded budget projections in both actual and cyclically-adjusted terms. At the same time, rising inflation through most of the year

caused widespread concerns among workers about real-wage erosion, leading to a renegotiation of the multi-year wage agreement reached earlier in the year. Moreover, the rising budget surplus fed public desires for additional tax cuts and spending increases. Shaped by these circumstances, the 2001 Budget gave rise to an Opinion by the European Council in February critical of the pro-cyclical fiscal stance. Subsequent indicators point to a welcome slowing of the economy, however, reducing potential risks from the fiscal stimulus. Nevertheless, events during the past year underscore the tensions in the Irish policy framework as the ongoing expansion matures.

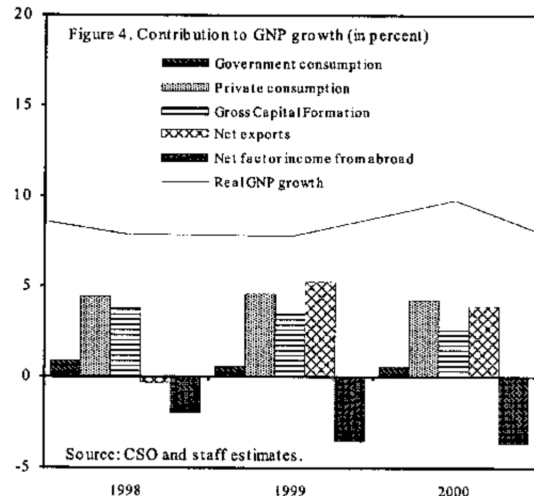
4. **Against this background, this staff report addresses two broad questions:**

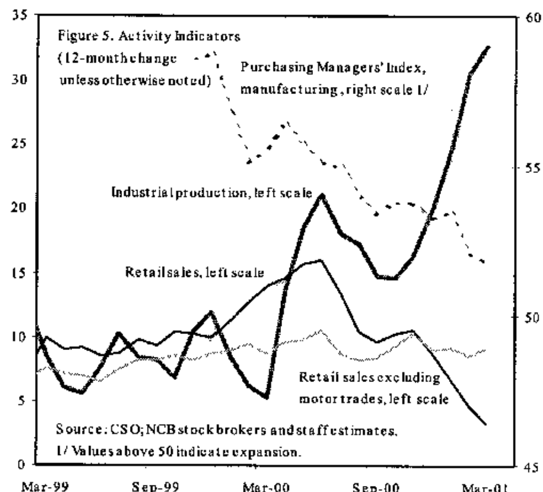
- How can policies ensure that neither upside nor downside risks jeopardize a smooth transition to a sustainable rate of growth?
- What institutional and structural reforms—notably with regard to wage determination—are needed to ensure that Ireland can sustain a high rate of growth over the medium term?

II. Background to the Discussions

A. Recent Economic Developments

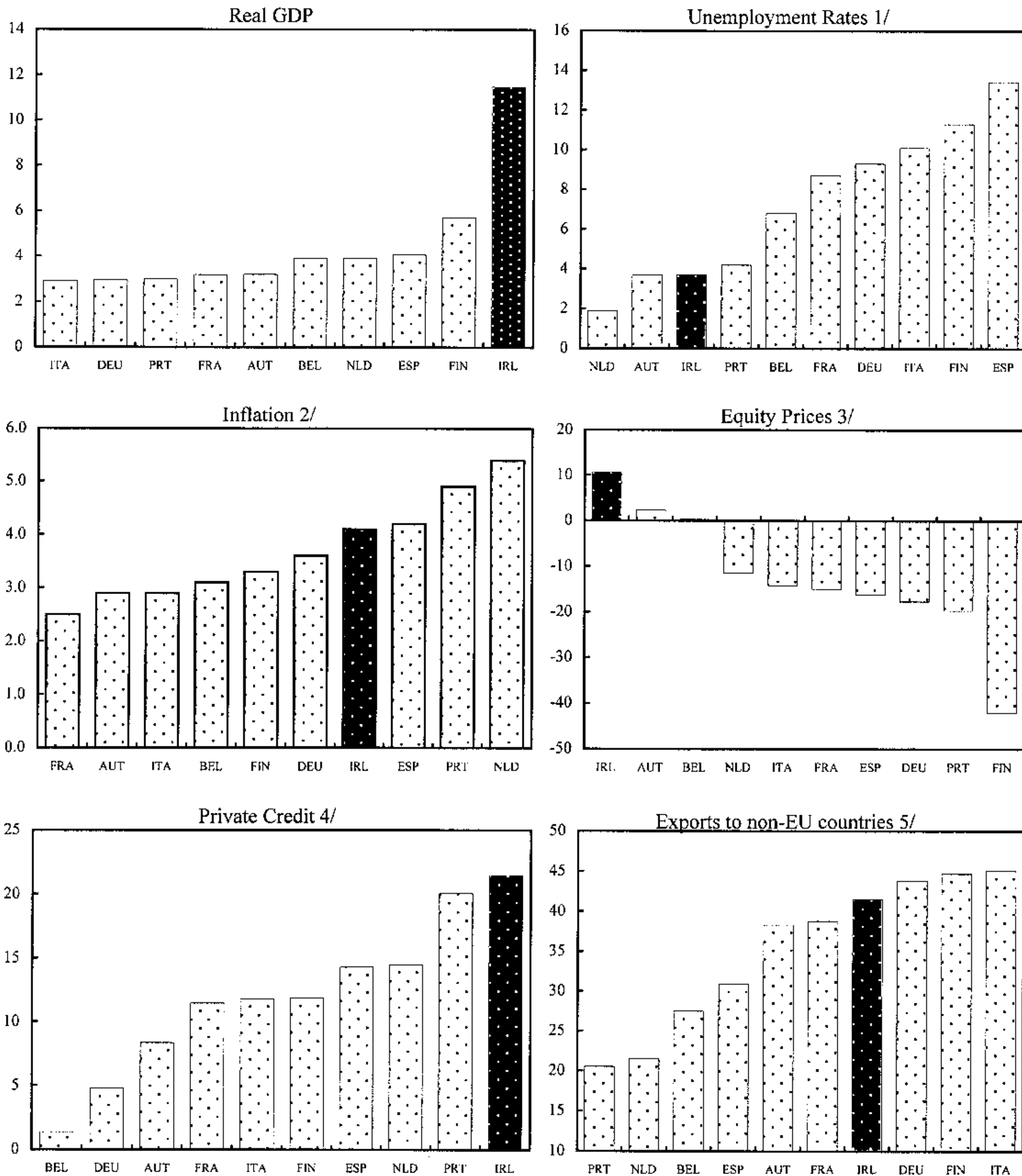
5. **Economic growth in 2000 far exceeded the rates observed in the rest of the euro area** (Figure 3). On the basis of preliminary data, real GDP grew by an estimated 11½ percent, boosted by strong growth in both domestic demand and exports (Table 1). Private consumption was mainly driven by rising employment and disposable-income growth, as well as by easy monetary conditions. Investment remained buoyant, but its contribution to growth declined somewhat, possibly reflecting increasingly binding capacity constraints and heightened uncertainty about the global outlook. In part a result of strong domestic demand, the external current account balance shifted from a small surplus to an estimated deficit of 0.9 percent of GDP in 2000 (Table 2).





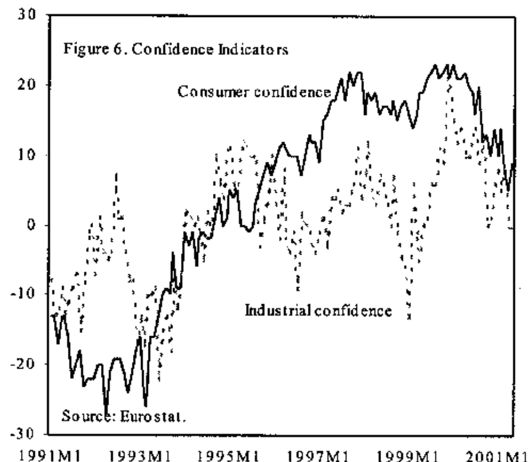
6. **Output growth appears to have moderated in the first few months of 2001.** Although industrial output continued to expand strongly, the growth of new orders slowed noticeably during the first quarter of 2001, due mainly to the global economic slowdown that also dampened consumer confidence. Restrictions on

Figure 3. Ireland: Comparisons of Key Indicators with Other Euro Area Countries
(Growth rates, in percent, unless otherwise indicated)



Source: WEO; IFS, Bloomberg; and staff estimates.
1/ May 2001 except for Portugal and Spain March 2001; 1st quarter 2001 for Italy; April 2001 for France.
2/ Twelve-month change in the EU Harmonized Index of Consumer Prices (HICP), May 2001.
3/ Three-month average, ending in May 2001, over corresponding period in 2000.
4/ Bank lending to residents other than monetary authorities and banking institutions. 12-month change, April 2001.
5/ As a share of total exports.

mobility associated with foot and mouth disease also contributed to a slowdown in services, particularly tourism and transport. Decelerating retail sales growth and lower-than-projected tax revenues also point to a weakening economic environment.



7. **The labor market continued to tighten, but the growth rates of both the labor force and employment have slowed markedly during the past year.** The leveling off in the participation rate contributed to the slowdown in labor force growth. Nonetheless, the employment rate remains well above the euro area average (Figure 7). Employment grew strongly during the year ending in the first quarter of 2001, albeit at a much slower pace than in the previous year (Figure 8). The unemployment rate (ILO definition) fell further to a record low of 3.7 percent in the three months ending February 2001.

Table 3. Labor Force and Employment Growth

Change, year-on-year (unless otherwise noted)

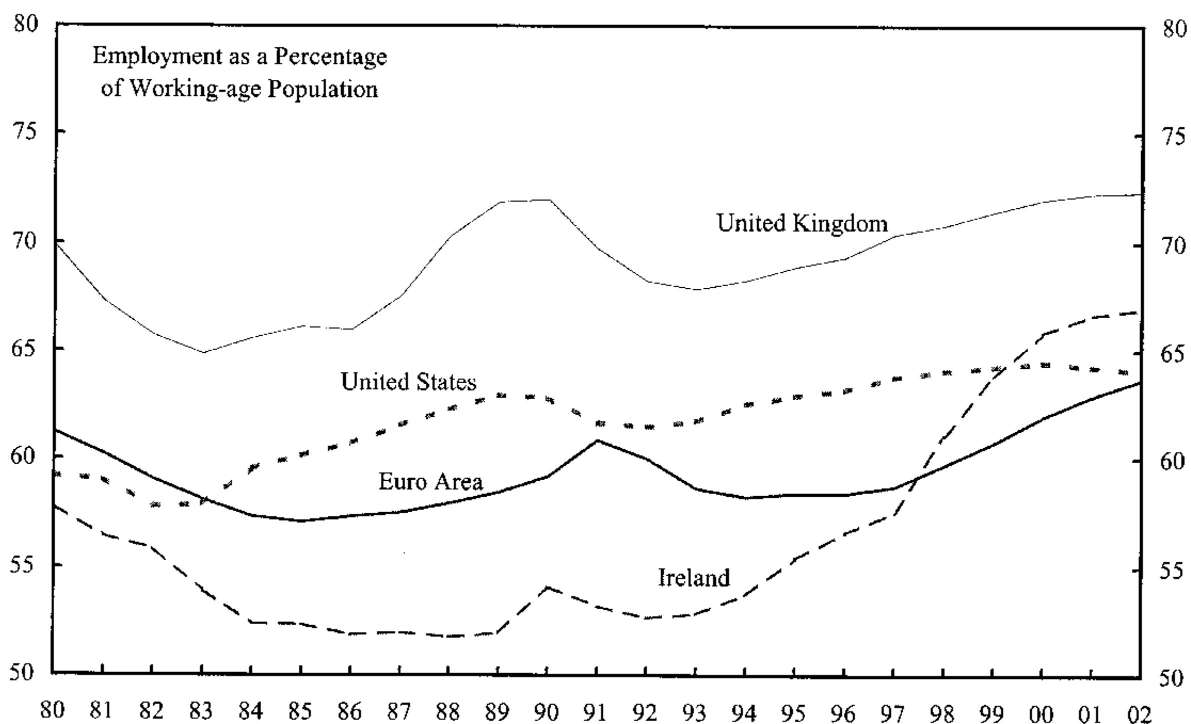
	Q1 1999	Q1 2000	Q1 2001
Labor force growth rate	1.8	5.0	2.5
of which due to			
Population growth	...	2.3	2.4
Participation growth	...	2.7	0.1
Change in			
Employment	4.9	6.1	3.6
Unemployment rate	-2.7	-1.1	-1.0
Memorandum items			
Participation rate of population aged 15 or over	56.7	58.6	58.9
Males	69.4	70.7	70.6
Females	44.5	46.8	47.6
Net migration (annual, thousands)	12.4	15.5	...

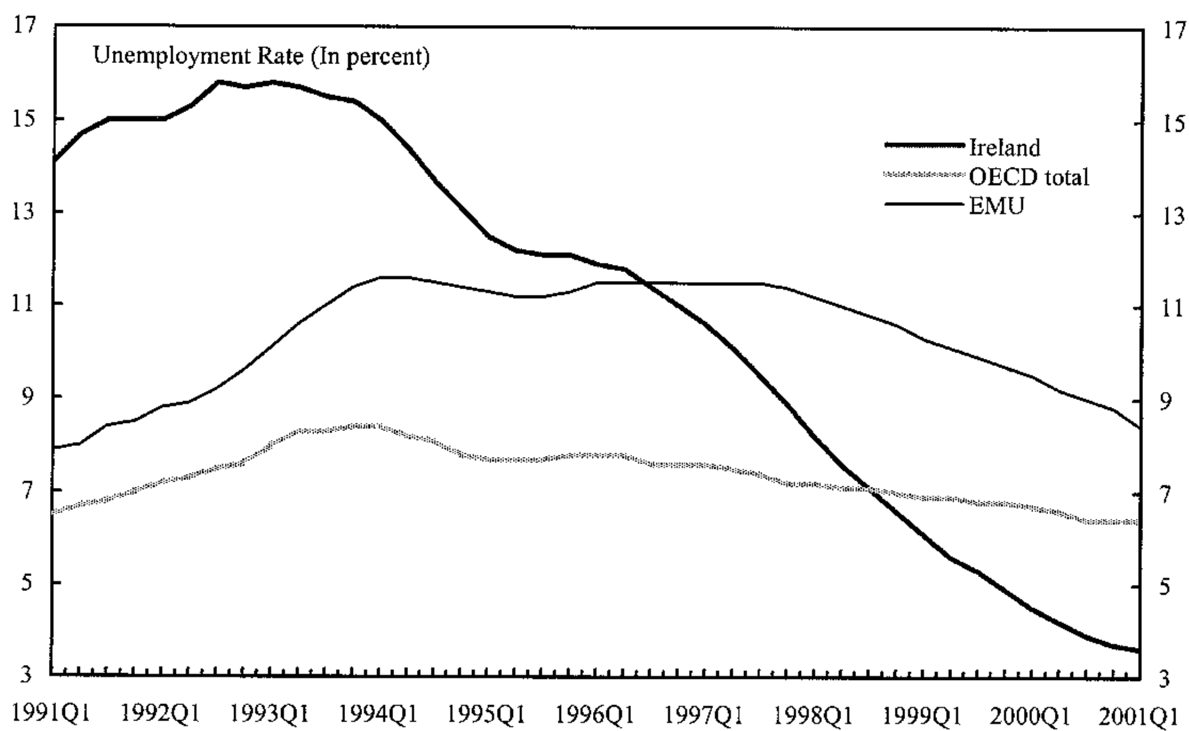
Source: CSO

8. **Reflecting tightening labor market conditions and higher inflation, nominal wage growth picked up in 2000, but given strong productivity increases, unit labor costs remained subdued.**[1] Hourly earnings in manufacturing rose at an annual rate of 6.2 percent

[1] Analysis of wage developments is seriously hampered by the lags in data availability and the lack of an overall earnings index (see paragraph 36). To the extent that irregular bonuses and other nonwage remuneration are prevalent, especially in sectors such as financial services, wage indices do not provide an accurate estimate of labor costs. Labor productivity data are out of date, but estimates are made for manufacturing—which accounts for almost 40 percent of GDP—from output and employment data.

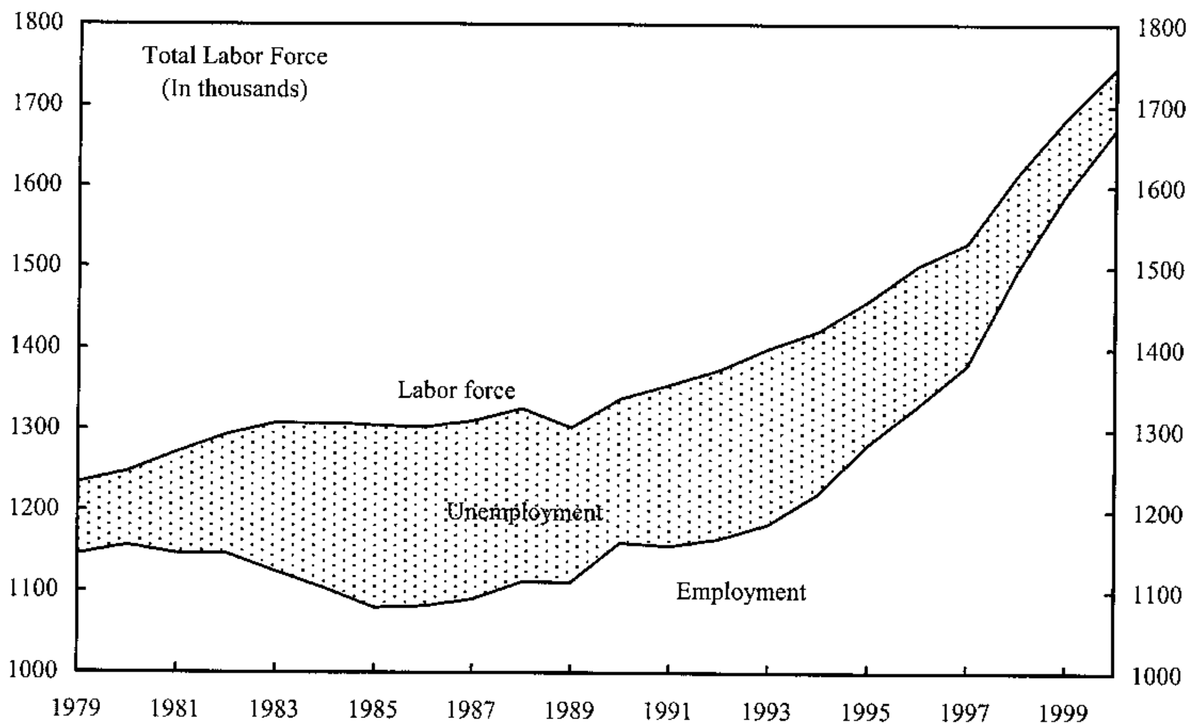
Figure 7. Ireland: Cross-country Comparisons of Labor Market Trends

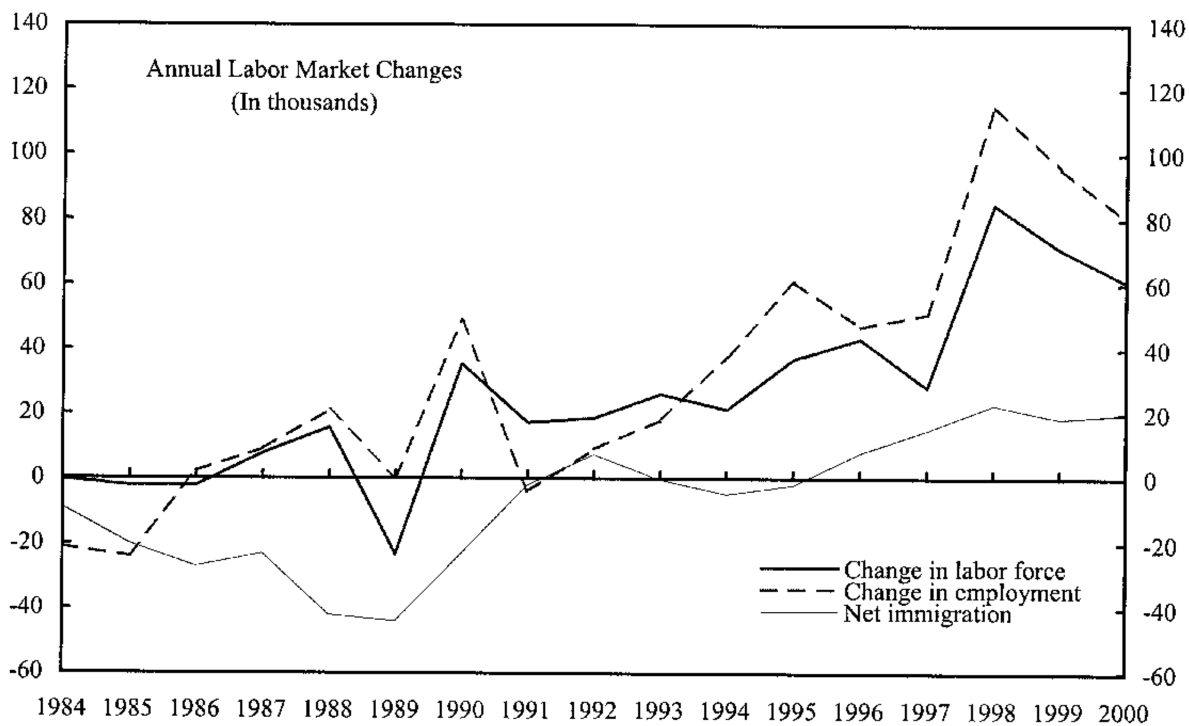




Source: Central Statistics Office; OECD Main Economic Indicators, and staff estimates.

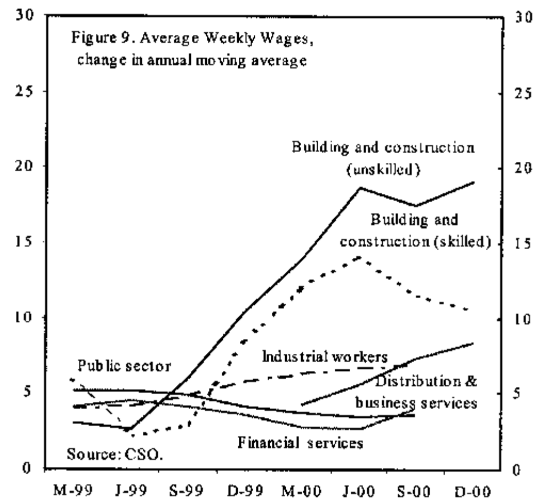
Figure 8. Ireland: Employment and Unemployment Developments



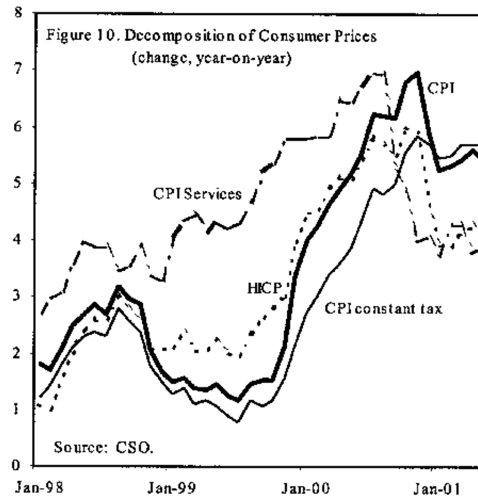


Source: CSO; OECD; and staff estimates.

in 2000 while unit labor costs are estimated to have declined by 3.8 percent (see Table 1). Wage growth also picked up in the service sector, although given the wide variation in the rates of increase, it is difficult to discern shifts in relative wages across sectors from the generalized increase in wages.



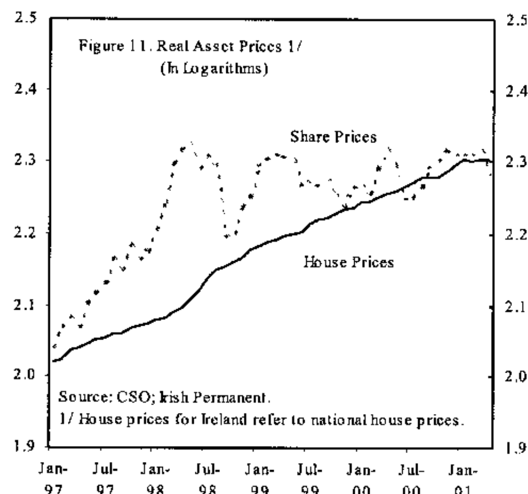
9. **Inflation picked up during 2000 and, although moderating subsequently, has remained well above the euro area average.** Higher energy prices and increases in indirect taxes contributed 1¼ and ¾ percentage points, respectively, to a headline national inflation rate of 5.6 percent (year-on-year) in 2000 (Figure 10). Given Ireland's openness, the weakness of the euro also contributed to last year's pick-up in inflation. By the same token, the recent decline in inflation partly reflects the temporary effects of a reduction in indirect taxes in last year's budget; the constant tax measure has remained broadly unchanged from its November peak. On a harmonized basis, year-on-year inflation peaked at 6 percent in November 2000 before falling back to 4.1 percent in May 2001.[2]



10. **Real estate prices continued to rise at a rapid clip in 2000, but the housing market appears to have slowed in the first few months of this year.** The 12-month rate of increase in house prices decelerated from 21.3 percent in December 2000 to 18.4 percent in April; in real terms, house prices rose by less than 2½ percent during the first four months of 2001. A number of factors contributed to this slowdown, including the rapid increase in housing supply last year; the depressing effect on demand of a significant increase in the

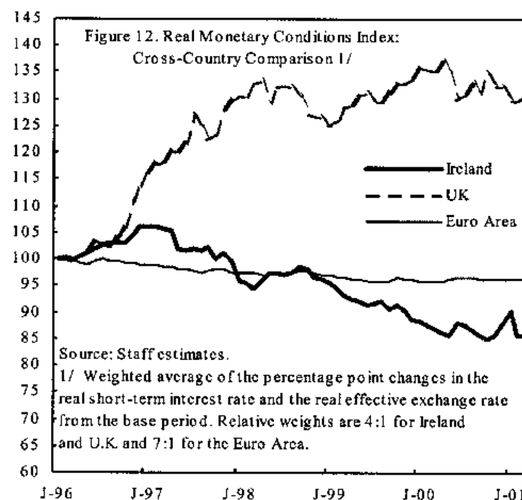
[2] The harmonized index differs from the national measures mainly in its exclusion of items that comprise about 8 percent of the national basket, including mortgage interest payments, and in its use of geometric rather than arithmetic, weights.

stamp duty on second homes (subsequently lowered); a tightening of lending standards by credit institutions; and dampened consumer confidence.[3] At the same time, recently-introduced regulations requiring a set-aside for low-cost housing in every new housing development appear to have contributed to a sharp fall in housing construction permits in recent months.



B. Policy Developments

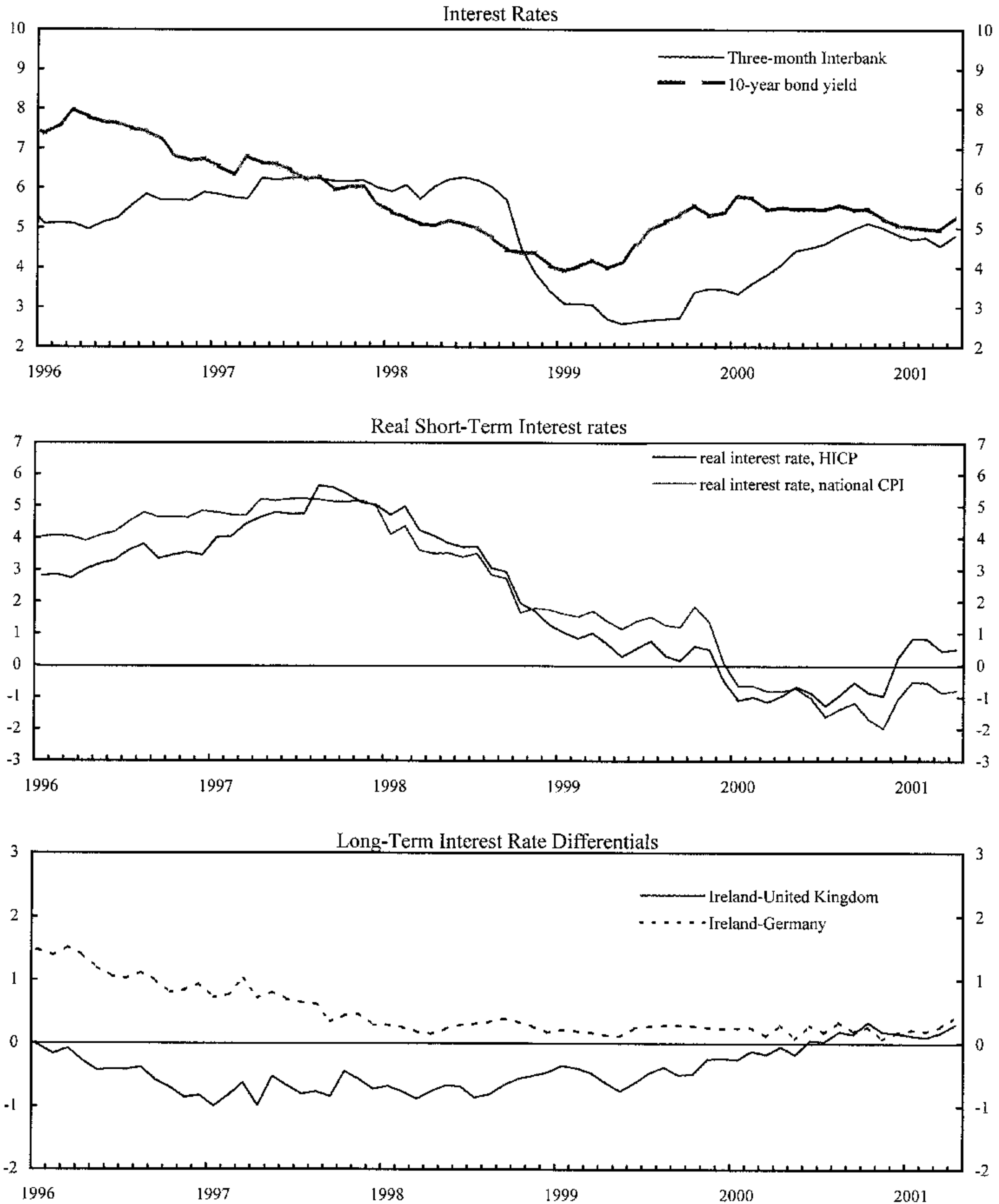
11. **Monetary conditions remained easy in 2000 and early 2001.** The cumulative 150-basis-point increase in the ECB's base rate between early 2000 and May 2001 (net of the most recent 25-basis-point rate cut) has not sufficiently offset the inflationary impact of the sustained depreciation of the euro. Moreover, real short-term interest rates remained negative for most of 2000 and early 2001 (Figure 13). These monetary conditions were reflected in strong private credit growth—fueled by mortgage lending and consumer credit—that peaked in March 2000. Annual credit growth slowed markedly to some 19 percent by May 2001, partly reflecting much lower automobile sales and, subsequently, a deceleration in the pace of economic growth and slower expansion of the housing market.[4] The moderation in credit growth may also reflect a winding down of a step adjustment in household and bank portfolios in response to the downward shift in



[3] With regard to other asset prices, the Irish share price index (the ISEQ) broadly maintained its value in real terms in 2000 and early 2001. The index is dominated by the stocks of the two largest banks—which remain highly profitable—and one pharmaceutical company.

[4] Automobile sales were exceptionally high last year, reportedly due to a widespread desire to have symbolically important year 2000 license plates.

Figure 13. Ireland: Interest Rate Developments, 1996-2001



Sources: Central Bank of Ireland, Quarterly Bulletin; and IMF, Surveillance Database.

the interest rate structure that followed monetary union.[5]

12. **As in previous years, the fiscal outturn for 2000 was stronger than projected.** Higher-than-expected GDP growth and exceptionally high automobile sales yielded additional revenue, while rapidly falling unemployment and debt service payments kept outlays in check. The general government surplus reached an estimated 4.6 percent of GDP and general government debt fell to an estimated 39.3 percent of GDP by end-year while assets in the pension reserve fund rose to 6.3 percent of GDP (Table 5).[6] The cyclically-adjusted budget balance remained broadly unchanged despite the tax cuts and spending measures introduced in the 2000 budget.[7]

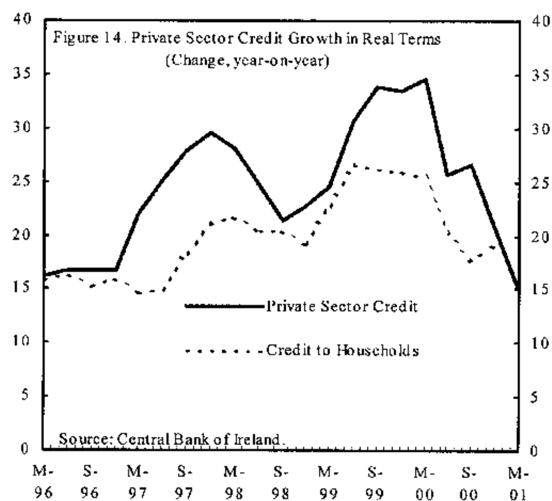


Table 4. Fiscal Stance, 1998-2001
(as a percent of GDP)

	1998	1999	2000	Proj. 2001
General government balance	2.1	3.9	4.6	3.5
Cyclically-adjusted budget balance (CABB)				
Overall	1.4	3.1	3.1	2.2
Primary	4.2	5.0	4.7	3.6
Change in the CABB				
Overall	1.4	1.7	0.0	-0.9
Primary	0.7	0.7	-0.3	-1.1

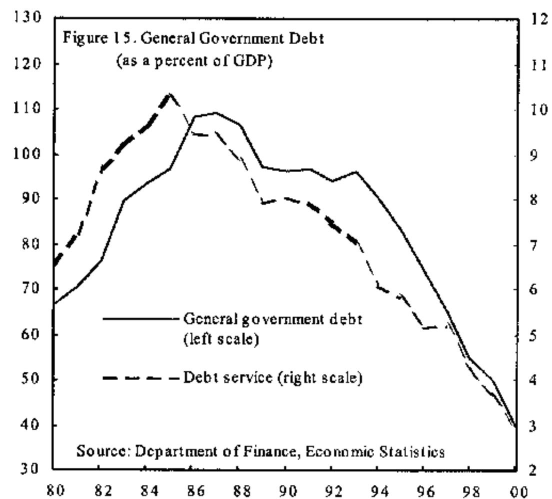
Source: Staff estimates

[5] Between end-1995 and end-2000, long-term bond yields and real short-term rates declined by about 4 percentage points. According to central bank estimates, private sector credit as a ratio to GDP rose from 71 percent to 109 percent while the ratio of household debt to disposable income rose from 48 percent to 67 percent.

[6] In 1999, the government created a pension reserve fund to which it committed to contributing 1 percent of GNP annually and in which it has also placed proceeds from privatization.

[7] Estimates of the cyclically-adjusted fiscal balances are subject to considerable uncertainty because of the difficulties in estimating potential output. See footnote 10 and Supplementary Note 1.

13. **The 2001 budget introduced tax and spending measures costing an estimated 1½ percentage points of GDP, with the projected budget surplus declining slightly to 4.3 percent of GDP** (see Tables 5 and 6). The main measures were as follows:



- On the tax side, the standard and higher marginal rates of income tax were lowered by 2 percentage points, bringing them to 20 and 42 percent, respectively; the basic personal tax allowances were increased; and the tax-rate bands were widened. The standard corporate tax rate was reduced by 4 percentage points to 20 percent, in line with the government's plan to unify the corporate tax rate at 12½ percent by 2003.[8] In addition, the standard VAT rate was lowered by 1 percentage point to 20 percent, and excise duties on diesel and unleaded petrol were reduced.

- On the spending side, including revised estimates introduced in March, current expenditure was projected to increase by 14.4 percent and gross capital spending by 28.6 percent. Social welfare expenditures—mainly pensions and child benefits—were projected to rise by 15.7 percent (compared with an increase of 6.9 percent in 2000). The public sector wage bill was scheduled to rise by more than 15 percent, of which 3½ percent reflected increased employment (mainly due to an expansion in health services); 10 percent a rise in average pay; and the rest increases

Table 7. Main Budgetary Measures in 2001
(as a percent of GDP)

	Estimated Cost
Revenues:	**1.38**
Income taxes	0.79
Corporate taxes	0.23
Indirect taxes	0.36
Expenditures:	**1.03**
Social welfare package	0.64
Health and children	0.20
Adjustment to pay terms of PPF	0.19
Revenue reflow to budget from all measures 1/	**-0.86**
Net cost to the budget	**1.55**

Source: Ministry of Finance, Budget 2001
1/ Second-round effects on tax collections of all budget measures

[8] Under the agreement with the European Commission the 10 percent rate applying to manufacturing and certain internationally traded services is to be raised to12½ percent and unified with the standard rate by 2003. However, existing operations that are currently eligible for the 10 percent rate will retain this rate until end-2005, in the International Financial Services Center (IFSC) and the Shannon Zone, and until end-2010 in the case of the others.

in public sector pensions, promotions, and compensation for greater average seniority.

14. **Staff projects a smaller fiscal surplus this year than envisaged in the budget.** This partly reflects a lower projection for GDP growth (see paragraph 17). More significantly, staff has marked down the revenue projection, based on tax receipts for the first five months of the year, which increased by 7.4 percent relative to the same period a year earlier, as compared with the 12.5 percent increase projected in the budget for the year as a whole. The weaker-than-projected revenue performance may reflect partly the basing of the 2001 budget revenue projection on the exceptionally high level of automobile sales last year (see footnote 4). Whatever the cause, given normal seasonality, it appears unlikely that revenues can pick up sufficiently in the remainder of the year to meet the budget target. As a result, staff projects a general government surplus that is 0.8 percentage points of GDP lower than the budget projection. Cyclically-adjusted estimates imply a fiscal stimulus of about 0.9 percent of GDP in 2001 (see Tables 4 and 5).[9]

Table 8. Comparison of Budget Projections
(as a percent of GDP)

	Authorities	Staff
Revenue	32.7	32.3
Expenditures	28.4	28.8
Surplus	4.3	3.5
Addendum:		
GDP (IR£ millions)	91,750	90,594

15. **The Programme for Prosperity and Fairness (PPF)—the centralized wage agreement among labor, business and the government—that had been in effect since March 2000 was amended in December in light of higher-than-expected inflation.** The agreement originally envisaged nominal increases in basic pay in the public and private sectors of 5½ percent per year for the first two years, and 4 percent for the last nine months of the agreement. The increases were augmented by tax cuts designed to yield a 25 percent increase in disposable incomes over the 33 months of the agreement. A Public Service Benchmarking Body was also established to examine public-private pay relativities and is to report its findings by June 2002. No formal inflation adjustment was included in the agreement, but when inflation in 2000 turned out more than 2 percentage points higher than expected, the social partners agreed in December to an additional 2 percent pay increase starting in April 2001, and a payment of 1 percent of each worker's annual wage in April 2002. In practice, the PPF does not bind the private sector, but it commits the government to cut taxes, increase social and infrastructure spending, and modernize the public sector.

[9] To the extent that high automobile sales in 2000 represented a shift in planned purchases from 2001 to 2000, cyclically-adjusted estimates may overstate the decline in structural revenues and the structural overall balance in 2001, and vice versa in 2000.

III. Policy Discussions

16. **Discussions focused on policies to achieve a smooth transition to a sustainable rate of growth as well as to secure a high rate of growth over the medium term.** There was general agreement that given the present projections for global demand, the outlook for Ireland was broadly favorable. In fact, given the concerns about overheating risks last year, the present slowdown was largely welcomed. However, there were substantial downside risks from a weaker-than-expected external environment. The staff and the authorities also considered additional risks that could arise from the domestic side as growth slowed from the very rapid pace of the last few years to a more sustainable rate. These are, in principle, two-fold: (i) excessive wage growth, due to the slow adjustment of expectations, that could cause an eventual loss of competitiveness; and (ii) asset price collapses that could depress domestic spending and create potential problems in the banking system. Discussions regarding the appropriate policy responses to these risks covered fiscal policy and financial sector supervision. With regard to sustaining high rates of growth over the medium term, given the openness of the economy, a strong policy framework and well-functioning markets will be needed to enable Ireland to adapt to changing international market conditions. Hence, discussions also emphasized the reform of the wage setting framework, particularly given risks of excessive public sector wage growth; deregulation and privatization; the medium-term fiscal framework; and statistical reporting, which, as an important input into decision-making, should not be overlooked.

A. Economic Outlook and Policies

Economic Outlook and Risks

17. **Economic growth is expected to slow markedly in 2001 and 2002, albeit to a still very strong rate.** Staff forecasts real GDP to grow by 7 percent this year and 6.2 percent next year, with output remaining above potential (see Table 1).[10] The slowdown in the U.S. and European economies and the sharply weaker outlook for the global technology sector are expected to curtail export and investment growth and to keep consumer confidence subdued in 2001. At the same time, easy monetary conditions, strong growth in disposable income, and low unemployment should support private consumption and residential investment. Export growth is expected to recover somewhat in 2002 with domestic demand growth slowing further to a sustainable pace. Absent substantial increases in participation rates and immigration, growth in the labor force will continue to slow and—with the economy

---

[10] It is particularly difficult to estimate potential GDP for Ireland because of the rapid structural changes in the economy and the relatively elastic labor supply. Most methodologies, including the staff's, amount in large part to trend-fitting exercises that do not adequately reflect the likely asymmetries in output gaps. For instance, the output gap in 1999-2001 is likely to be overestimated since unit labor costs do not suggest significant upward wage pressures. See Supplementary Note 1.

approaching full employment—output growth will moderate in 2002 and thereafter, even if labor productivity continues to grow rapidly. These projections were broadly in line with the authorities' views as well as private sector forecasts.[11]

18. **The authorities and staff agreed that the outlook remains broadly favorable, but there were risks that the economy could slow by more than projected.** In the short run, weaker-than-anticipated external—particularly European—demand growth or a further slowdown in the global technology sector could lower export and investment growth as well as consumer confidence more than currently projected. Given the openness of the Irish economy and the prominence of U.S.-owned multinational investment, especially in the technology sector, there is a heightened risk that further external shocks could precipitate a more abrupt and significant slowdown than currently projected. In the medium term, a significant appreciation of the euro vis-à-vis the dollar or sterling could have a negative impact on exports and employment, especially amongst the more labor-intensive locally-owned companies. In addition, with wage growth expected to be about 10 percent in 2001,[12] there are risks that if such increases were to continue, competitiveness could eventually decline—particularly vis-à-vis third country competitors in major markets—and curtail medium term growth. However, even if some of these downside risks materialize, there appears to be little risk that these problems would cause serious stresses on the financial system (see paragraph 25).

19. **Although inflation remains above the euro area average and wage growth is strong, there is little evidence that prices and wages are currently overshooting sustainable trends.** The pick up in inflation in 2000 and early 2001 reflects mainly temporary or external factors (see paragraph 9). The remaining—more stable—inflation differential of about 1-2 percentage points is in the range of estimates of the trend differential to be expected from Balassa-Samuelson effects arising from Ireland's strong relative

[11] The Department of Finance was in the process of revising its projection of 8.8 percent GDP growth in 2001 made at the time of the budget last December. The central bank projects a GDP growth rate of 6.5 percent and the Economic and Social Research Institute, a think tank, a rate of 6.7 percent in 2001; the May consensus forecast was at 6.9 percent. Staff's projection is somewhat higher than the 5.2 percentage point reduction in GDP (relative to the baseline projection) envisaged in the scenario in Annex II of the staff report to the 2000 Article IV consultation (IMF Staff Country Report 00/97), August 2000, which assumed a "hard landing" in the United States, but a much larger appreciation of the euro vis-à-vis the US dollar and sterling than has occurred.

[12] Central Bank forecast for nonagricultural earnings per worker. See Central Bank of Ireland, *Quarterly Bulletin,* Spring 2001, p. 38. Private forecasters also broadly agreed with this estimate.

productivity growth in tradables.[13] Given its openness and participation in EMU, Ireland's inflation is mainly externally generated. The two primary sources of "overheating" risk stem from a break in the link between wages and productivity or unsustainable increases in the prices of immobile assets such as real estate.

- On wages, although analysis is seriously hampered by data deficiencies, estimates suggest that wage growth of about 10 percent this year reflects a partial catching up of earlier productivity gains and would not jeopardize competitiveness (Box 1). Many private sector analysts shared this view, but the authorities saw a greater risk that this year's wage increases would erode competitiveness in the years ahead. Staff agreed that continued wage growth in excess of productivity growth would raise inflation and slow medium-term growth, but noted that it was important to recognize that, in a monetary union, relative wage adjustment (i.e., increases in relative unit labor costs that reduce competitiveness) is, to some extent, an equilibrating mechanism through which cyclically-advanced economies returned to a sustainable rate of growth.[14]

- On real estate prices, the recent gradual cooling of the housing market reduces the risk of a disorderly downward correction in house prices.[15] Nevertheless, the equilibrium relative price of housing is likely to keep rising for some time because of the demand for additional housing spurred by the rapid rate of new household formation—reflecting demographic trends and immigration—and rising real incomes.[16] In recent

---

[13] For estimates of such effects by staff and others, see Chapter I of the Selected Issues volume for the 1999 Article IV consultation for Ireland, "Ireland and the Euro: Productivity Growth, Inflation, and the Real Exchange Rate," (IMF Staff Country Report 99/108), October 1999, and A. Alesina et al., "Defining a Macroeconomic Framework for the Euro Area" *Monitoring the European Central Bank* (3), Center for Economic Policy Research, 2001.

[14] For further discussion of this mechanism, see Alesina et al., "Defining a Macroeconomic Framework for the Euro Area" *Monitoring the European Central Bank* (3), Center for Economic Policy Research, 2001,

[15] For instance, the annual growth in prices of existing houses in Dublin has declined from a peak of 42 percent in 1998 to 10.8 percent in 2000. For a detailed assessment of the housing market see the *Selected Issues* paper for the 2000 Article IV consultation with Ireland, "Ireland's Property Boom from an International Perspective" (IMF Staff Country Report 00/99), August 2000. The paper concluded that "the risks may arise not so much from a price decline now, as from the possibility that rapid price increases may persist, leading to a greater overshooting and a sharper future decline." In addition, given EMU, the prospect seems unlikely of a sharp rise in real interest rates—a factor that contributed to the collapse in real estate prices in some countries.

[16] Average household size in Ireland has fallen to 2.95 in 2000 from 3.28 in 1991, but is still above the EU average of 2.5. According to the authorities, although Ireland has the highest

(continued)

years, the housing market responded with an acceleration of new construction. However, construction permits fell off sharply early this year, at least partly due to inadequate administrative capacity to process construction applications, and uncertainty over the implications of the regulations on low-income housing set-asides. Given the risk of a reversal in the deceleration in house price inflation, the mission stressed that the elimination of these regulatory and administrative bottlenecks should be a priority. In addition, supervisory vigilance is key to ensuring that should a sharp downward adjustment in real estate prices occur, it will not pose a systemic risk to the financial sector (see paragraphs 25 and 26).[17]

Fiscal Policy

20. **Staff argued that a neutral fiscal stance—that is, an unchanged cyclically-adjusted budget balance—would have been appropriate this year, and would be in 2002 as well.** From a medium-term perspective, there is no need for fiscal policy to be biased towards a structural tightening or loosening. Under current policies, Ireland's medium-term fiscal outlook appears appropriately strong—even allowing for a gradual slowing of GDP growth—due to a rapidly falling gross public debt ratio, favorable demographics, and the build-up of a pension reserve fund (see Table 6). From a short-term perspective, in view of the difficulties in precisely estimating Ireland's cyclical position and the well-known lags in adjusting fiscal policy, aiming for a neutral stance would be preferable to attempting to run counter-cyclical fiscal policy (beyond the operation of the automatic stabilizers)—other than to address serious overheating or recession, neither of which is currently a significant threat.[18] In that light, fiscal policy should not have been expansionary in 2001, all the more so given the still-strong cyclical position. While various factors suggest that the effective

---

rate of house building relative to population (13.1 units per 1000 persons in 2000), it still has the smallest housing stock relative to population (an estimated 335 units per 1000 persons in 1999 compared with an estimated EU average of 440 units).

[17] While there are parallels—most notably in the macroeconomic environment—between Ireland's current situation and, for example, the Nordic countries in the 1980s, there are also important differences: Ireland's banking sector has a long history of operating in an open, deregulated market, and it is well capitalized. Furthermore, as a member of common currency area Ireland is much less prone to sudden interest and exchange rate shocks. For a further discussion, see "The Nordic Banking Crises", IMF Occasional Paper 161, 1998.

[18] For a detailed discussion of macroeconomic policies in cyclically-advanced economies in the euro area and the difficulties with attempting to run countercyclical fiscal policy, see the *Selected Issues* paper for the 2001 Article IV consultation with the Netherlands, "Cyclically Advanced Euro-Area Economies—Consequences and Policy Options," (IMF Country Report 01/95), July 2001. The paper argued that fiscal policy in such economies should, at a minimum, be neutral with automatic stabilizers given full play.

stimulus is not likely to be large (see Supplementary Note 1), such a stance is nonetheless procyclical. Given the slowing economy and the diminished risks of overheating, offsetting mid-year fiscal measures are not warranted, but underspending this year should be saved in order to minimize the fiscal stimulus. For 2002, with output expected to remain above potential, but the cyclical gap closing, a neutral stance would be again appropriate. Thus, any further tax cuts should be matched by expenditure increases small enough to keep the cyclically-adjusted overall balance unchanged. [19]

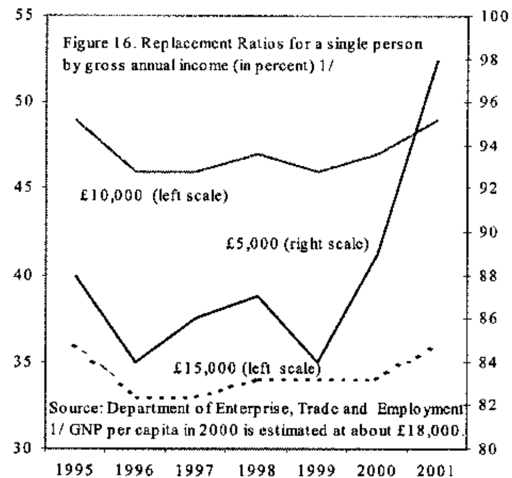
21. **The authorities noted that the demand effects of fiscal policy were less significant in as open an economy as Ireland.** Given such limited effects, budget surpluses would have to be raised to unrealistically high levels to act as a significant restraint on domestic demand growth. They considered that fiscal policy should be—and is—geared to ensuring a strong position over the medium term, bolstered by supply side measures, especially on taxation and infrastructure investment, necessary to sustain a high rate of output growth. The mission supported these aims and agreed that there is little argument for a fiscal tightening this year, especially with the economy slowing on its own accord. Staff noted, however, that fiscal policy is likely to be more effective now than in the past since EMU membership had eliminated the possibility that interest rate and exchange rate movements would offset a fiscal expansion. In addition, even if fiscal policy had limited effects on tradable prices, it would still affect the relative price of nontradables—both labor and assets such as houses. It would thus be important to avoid a pro-cyclical stance.

22. **The mission stressed that, unlike in past years, revenues were likely to underperform budget projections in 2001 and that spending should therefore be held tightly to budgeted levels to limit the expansionary impulse.** In recent years, revenue outturns have substantially exceeded budget projections because actual GDP grew much more strongly than anticipated. Staff cautioned that an underperformance was more likely this year—as suggested by tax collections thus far—because the GDP growth projections underlying the 2001 budget now looked optimistic and because budget revenue projections appeared to be based on exceptionally high revenues in 2000. The authorities acknowledged these points, but expected tax receipts for the year to come in close to budget. They assured the mission that government departments had already been warned of the importance this year, more than in years past, of holding expenditures to budgeted levels.

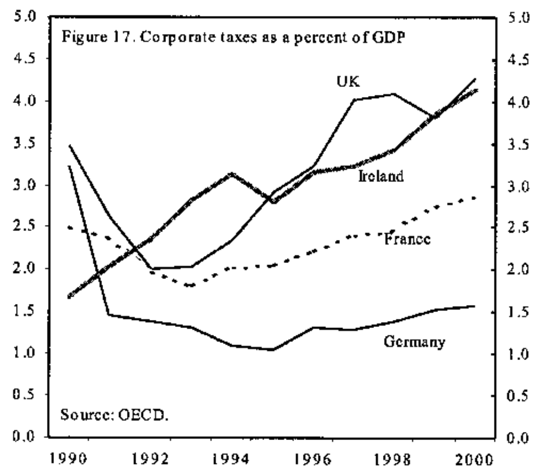
23. **Discussions also covered the structural aspects of budget policies.** On current expenditures, the authorities noted that public sector wages would need to be kept under control, especially since the benchmarking exercise was likely to increase rather than reduce average pay, at least initially. The mission agreed, underscoring the need more broadly to

[19] Given the likely expansionary stance in 2001, it could be argued, in principle, that maintaining a generally neutral fiscal stance would require a fiscal contraction in 2002. However, given the contractionary fiscal impulses over the last several years, this does not appear warranted (See Supplementary Note 1).

reform the approach to public sector pay determination and, in the meantime, to avoid breaching the norm set in the renegotiated PPF, notwithstanding the threat of labor unrest (see paragraphs 29–31). In addition, staff noted that the rate of growth of social welfare payments should be kept in line with wage increases to avoid undoing the reductions in replacement ratios that have facilitated the remarkable decline in unemployment in recent years.[20] On capital expenditures, the authorities emphasized that Ireland's physical infrastructure—especially roads, public transport, and supporting infrastructure for the expansion of housing—needed improvement, as set out in the National Development Plan. They agreed that, given capacity constraints and sharp price increases in the construction industry, capital projects needed to be prioritized, and that importing temporary labor for construction—as had happened recently on some projects—might be necessary.



24. **The authorities emphasized the supply enhancing effects of the recent reforms to taxation.** Over the last several years, they had reduced income tax rates and widened the tax rate bands, substantially mitigating tax distortions to labor supply decisions. Given the rapid growth in incomes, these actions were also necessary to avoid fiscal drag (See Supplementary Note 1). The mission noted that if the rate bands were price-indexed, at least the fiscal drag due purely to inflation could have been avoided automatically, although this would not have obviated discretionary action in response to strong real growth. On corporate taxes, the government's reform plans have already been announced. Despite the reduction in the standard corporate tax rate so far—from 43 percent in 1991 to 20 percent in 2001—corporate tax revenues have been rising as a proportion to GDP. This ratio remains at the high end of the range in EU countries despite the relatively low statutory rates because of the relatively broad base to which they are



[20] The replacement ratio is defined as the ratio of benefits received when unemployed (from social welfare payments, unemployment insurance) to the after-tax income when employed. A fall in the replacement ratio signals an increase in incentives to work.

applied and the higher ratio of profits to GDP in Ireland. On social security taxes (PRSI), the mission noted that the removal of the cap on wages subject to employer contributions and the absence of a cap on health levies imply a high marginal tax rate on the total compensation of the most productive workers. The removal of the cap on PRSI, to a large extent, negates the reductions in the top rate of income tax.[21] Hence a comprehensive reform of the PRSI, addressing the structure of both benefits and contributions as well as the interaction with the income tax regime could be considered. The authorities were skeptical that the burden associated with the removal of the cap would fall mainly on employees, and noted that Ireland had relatively low employer social security contributions as a ratio to GDP compared with other European countries. With regard to the VAT, staff suggested there was scope for broadening the base and standardizing the rates to minimize the distortionary effects on consumption.

Financial Sector Supervision

25. **The authorities were confident that neither the slowdown in growth nor the softening of the housing market would pose any significant difficulties for the banking system.** Projected changes in these variables were well within the parameters of the stress tests carried out on credit institutions last November, which indicated a broadly robust banking sector. They noted that banks had become more cautious in their lending this year—including for residential mortgages— given weakening external prospects and concerns over growth and employment. A preliminary analysis of macro- and micro-prudential indicators for 2000-2001 suggests no significant changes in financial sector vulnerability (Table 9). Credit growth to the construction and (residential and commercial) real estate sectors is slowing, although exposure to these sectors remains high, especially among the smaller mortgage lenders.[22]

26. **The supervisory authorities are focusing their efforts in the areas identified by last year's FSAP.** The FSSA concluded that Ireland's banking system is well capitalized and adequately liquid, with the overall framework for prudential regulation and supervision sufficiently developed to address such risks (Box 2). The authorities noted that they were sharpening their focus on systemic issues through continued improvements in stress testing and by introducing thematic on-site inspections targeting key lending areas, such as residential mortgages and commercial real estate credits. The results were being used to focus supervisors' efforts on institutions where risk management practices needed improvement. The authorities were also applying differentiated capital requirements to

---

[21] Although this increases PRSI contributions of the employer, the *incidence* of the tax in an open economy such as Ireland would fall mainly on employees because Ireland is mostly a price-taker in international markets.

[22] Financial institutions' off-balance sheet business also increased, but these data include the activities of International Financial Services Center entities.

ensure that smaller, less diversified mortgage lenders remained adequately capitalized. The mission welcomed these efforts and encouraged further progress in developing forward-looking assessments of overall financial system stability, especially through the integration of macroprudential and microprudential analysis.

27. **The decision to establish a single regulator, has eliminated uncertainty over this issue and will minimize any opportunities for regulatory arbitrage.** [23] The new organizational structure provides mechanisms for coordination between the branches of the central bank responsible for monetary policy and financial supervision, respectively, that should strengthen its work on systemic stability issues. The authorities had also issued a number of guidelines to the insurance industry along the lines suggested by the FSAP, but a substantial increase in specialized resources to strengthen insurance supervision would need to await the establishment of the single regulator at the beginning of next year.

28. **The authorities welcomed the mission's suggestion for an update of the FSSA during the next Article IV consultation.** Such an update would be useful in assessing the impact of slower growth and decelerating real estate price inflation on financial system risks as well as the integration of supervision under the single regulator, especially the focus on systemic stability and capacity for responding to potential financial system emergencies.

B. Framework Issues and Policies

National Wage Agreement

29. **A well-functioning labor market will be key to absorbing external shocks and maintaining high growth over the medium term and, in this connection, the national wage agreements may be outliving their usefulness in their present form.** Cumulative nominal wage increases—although not undermining competitiveness—have, on average, exceeded the norms of each agreement from 1987-99 for both the public and private sectors (see Supplementary Note 2). As the labor market tightens, agreements may become less effective in restraining wage growth to rates justified by productivity gains.[24] Moreover,

---

[23] In February 2001, the government announced its decision to establish the single regulator within the central bank with insurance supervision to be transferred from the Department of Enterprise, Trade and Employment. The monetary policy and financial supervision functions are to be carried out in a parallel structure under the overall leadership of the Governor of the central bank. At the time of the discussions, the legislation establishing the single regulator was in its second draft, with Parliamentary approval expected by end-year.

[24] In its Spring 2001 *Quarterly Bulletin*, for instance, the central bank notes that "(e)vidence of wage increases from a number of sectors shows that, when labour shortages arise, market pressures have a strong influence on wage formation even when national incomes policies are in place…(i)t is important that the social partnership process is flexible enough to

(continued)

almost all the dissatisfaction over wages in the last few years has emanated from the public sector, suggesting a need for a broadly accepted system for determining public sector pay. In addition, these agreements have tended to weaken the links between productivity and wages and to discourage wage dispersion. Finally, trading tax cuts and spending increases for wage moderation risks imparting a pro-cyclical bias to fiscal policy and could lead to tax and spending decisions that may not necessarily be justified on their own merits.

30. **Although there was a consensus amongst private and public sector participants in the discussions that the national wage agreements needed to be reformed, there was little agreement on what form these reforms might take.** [25] The authorities acknowledged the need to rethink the structure of the agreements, but emphasized that the social consensus approach had been useful in minimizing the labor unrest experienced in earlier decades and might still be of value in this respect. In addition, the wage norms had been helpful in influencing wage expectations—a view shared by some employers—although public acceptance of wage differentiation was increasingly taking hold. Many private sector representatives noted that with wage pressures rising as the labor market tightened and increasing pressure on fiscal resources, the strategy of attempting to buy wage moderation through fiscal concessions was becoming increasingly untenable.

31. **While recognizing that the partnership approach had a continuing role to play in the broader social dialogue on such aspects as working conditions and job flexibility, the mission suggested substantial reforms to future wage agreements.** In particular, the approach should reflect two principles that would also automatically preclude the trading of tax cuts and spending increases for the acceptance of a wage package.

- Wages should reflect market forces to obtain an efficient allocation of labor. Given the discipline on the private sector imposed by the market—especially the global market—the simplest and most transparent option may be to exclude the wages of private sector workers from future agreements. There is ample evidence that private sector wages have, in any case, been responding to market pressures rather than to the national norms, and that private labor markets operate relatively flexibly.

- Public and private sector pay for comparable jobs should be aligned, including by allowing for greater differentiation in public sector pay. The mission noted that the benchmarking exercise was a positive step, provided that the comparators are chosen in an objective manner (with appropriate weight given to nonwage differentials such as job security and pension benefits). If successful, it could be periodically repeated to

---

accommodate diverse pay pressures, particularly in the event of an economic downturn." (pp. 35, 37).

[25] Some proposals have been made recently by ESRI, but they do not address the weaknesses the staff considers to be the most significant. See Supplementary Note 2.

form the basis of a public sector pay determination system linked to private sector comparators. In addition, exposing the public sector to greater competition from the private sector would increase discipline in public enterprise wage determination.

The authorities appreciated the mission's assessment, but noted that the private labor market's response to an adverse shock was uncertain—given the absence of such shocks in recent years—as was the public sector workers' acceptance of greater pay differentiation.

Deregulation and Privatization

32. **Strengthening competition through privatization and regulatory reform are key to securing a high sustainable growth rate in the future.** Despite some progress in recent years, broader and accelerated privatization and regulatory reform was essential to improve efficiency, maintain Ireland's attractiveness as a destination for FDI, and increase consumer choice. Staff noted that the utilities (especially electricity), public transportation, and the retail food sector were particular priorities. Moreover, as noted above, enhanced competition is critical to tightening the linkage between wages and productivity in the public sector. Although the authorities generally agreed with the mission's views, they stressed that the acceleration and broadening of competition-enhancing reforms were politically difficult, and would take time. They observed that the privatization of the telephone company and the recent liberalization of the Dublin taxi service—which had been extremely unpopular among existing license holders—illustrated the government's resolve to make progress in this area.

Medium-term Fiscal Framework

33. **Staff suggested that greater clarity regarding medium-term fiscal objectives and budget strategy would be useful, especially in helping the private sector make more informed decisions and reducing uncertainty.** Despite a strong medium- term fiscal position, budget pressures are increasing, with calls for further tax cuts on the one hand and higher public expenditures—given past under-investment in physical infrastructure, health care, and other essential services—on the other. These potentially conflicting demands need to be reconciled in an explicit budget strategy setting out the Government's tax and spending priorities, taking into account macroeconomic policy objectives and the likely moderation of economic growth over the medium term. Explicit multi-year commitments on tax reform, rather than incremental annual changes, would help increase the predictability of fiscal policy, with benefits for private sector decision making. Given the broader benefits from transparency, staff encouraged the authorities to undertake a Report on the Observance of Standards and Codes (ROSC) on fiscal transparency to identify areas for further improvement.

34. **The mission stressed that the allocation of increased public resources to specific sectors should flow from a comprehensive analysis of both the needs of the public and the alternative means for addressing them—including through greater private provision of services.** Establishing medium-term plans for the structure of the health and education sectors—as done by the National Development Plan for public infrastructure—

would provide a framework for setting spending priorities. Such plans should go hand-in-hand with mechanisms for improving accountability and transparency in the provision of services, with spending departments making explicit public commitments—with appropriate benchmarks for monitoring progress—on the delivery of services within budgeted amounts.

35. **The authorities were open to these suggestions, noting that some elements of a medium-term approach to expenditure allocation were already in place.** These included a rolling three-year analysis of the cost of providing services at their existing level, the Government's Action Programme for the Millennium, the National Development Plan, and the PPF. A new multi-annual strategy for the health services was also being prepared for publication in this summer. While welcoming these efforts, staff stressed the need to ensure such strategies are conceived comprehensively, not incrementally.

Other Issues

36. **Ireland's macroeconomic data are broadly adequate for analyzing developments from a longer-term perspective, but there is a need to improve the coverage and timeliness of data necessary for short-term surveillance.** Ireland has subscribed to the Special Data Dissemination Standards (SDDS) and its metadata are posted on the DSBB (see Appendix III). While noting the progress with regard to the publication of macroeconomic data, the mission urged the authorities to improve the reporting of many key data essential for monitoring short-term developments. In particular, the timeliness of national income accounts, productivity, and wage data need to be improved and an overall earnings index published. Sectoral balance sheet data also need to be constructed and published. With respect to budget data, more details should be published on public compensation expenditures as well as the linkages among the budget, the national accounts, and the Stability Programme at the time the budget is announced. The authorities noted that resources were being stretched thin in responding to the increased demand for statistics from EU and euro area institutions. The resources for the Central Statistics office had been increased in the 2001 budget, but there were many practical difficulties in increasing capacity quickly. They intended to give immediate attention to improving wage bill data in the budget and would work over the medium term to improve the data linkages amongst the budget and other accounts.

37. **The Irish authorities are preparing intensively for the changeover to the euro at the beginning of next year.** The changeover involves a substantial logistical effort given the relatively large proportion of cash transactions in the Irish economy.

38. **In June 2001, in a referendum, Ireland rejected the Nice Treaty for the expansion of the EU.** The authorities have indicated that a period of assessment will be needed before finding a mutually acceptable way forward.

39. **Ireland is expected to ratify the OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions following enactment of the necessary legislation on July 9.** The legislation will also enable Ireland to ratify a

number of conventions dealing with corruption drawn up by the European Union and the Council of Europe.

40. The allocation of official development assistance was increased in the 2001 budget from 0.30 percent of GNP to 0.34 percent of GNP.

IV. STAFF APPRAISAL

41. **The performance of the Irish economy has been impressive.** A 15-year expansion, capped by five years of very high output and employment growth, raised per capita income above the euro area average last year and reduced the unemployment rate to a record low early this year. Sound fiscal policies have led to sizeable surpluses and a rapidly declining public debt to GDP ratio. Resource utilization remains high, but concerns last year about overheating have been assuaged by a welcome moderation in demand and output growth brought about in large part by the weakening global environment.

42. **The outlook is broadly favorable, but there are risks to achieving a smooth transition to a sustainable rate of growth.** Given the downside risks from weaker-than-anticipated global demand growth, especially in the technology sector, it will be important that wages and prices respond flexibly to potential external shocks. On the domestic front, wages appear to be increasing strongly this year, but are unlikely to jeopardize Irish competitiveness. Continued wage increases in excess of productivity growth would raise inflation and slow medium-term growth, but in a monetary union, such relative wage adjustment is, to some extent, an equilibrating mechanism that lowers aggregate demand and brings output growth back to a sustainable rate. The deceleration in house price inflation since early this year has reduced the risk of a disorderly downward correction in real estate prices. Nevertheless, even if some of these downside risks were to materialize, serious systemic stresses in the financial sector appear unlikely.

43. **The fiscal stance in 2001 should have been neutral rather than expansionary, and it will be important to prevent a further fiscal impulse in 2002.** Since the risks of serious overheating or recession are not significant, and given the difficulties in running counter-cyclical policy (beyond the operation of the automatic stabilizers), it would be best to aim for a neutral stance in these years. The authorities' focus on maintaining medium-term fiscal strength and reducing supply side distortions through tax and spending measures is appropriate, but given the still-strong cyclical position, the procyclical implications of these policies cannot be ignored. Although mid-year fiscal measures are not warranted in 2001 given slowing growth, public expenditure should be held tightly to budgeted levels and any underspending saved to mitigate the fiscal easing. For 2002, any procyclical effects of improvements to the structure of taxes or expenditure should be curtailed through offsetting measures elsewhere in the budget.

44. **The government's reform of the tax structure is commendable and scope remains for further rationalization in certain areas.** Discretionary actions in the form of tax rate reductions and a broadening of rate bands have been needed to avoid fiscal drag and

have reduced tax distortion of labor supply decisions. The social security (PRSI) tax regime would benefit from reform, particularly with an eye to rationalizing how these taxes interact with income taxes. There is also scope for broadening the VAT base and standardizing the rates to minimize the distortion of consumption decisions.

45. **A key objective with regard to expenditures is to keep public sector wages under control.** The pay norm set in the renegotiated PPF should not be breached and further wage pressures—particularly from attempts by different groups to leapfrog over each other's pay increases—must be resisted. There is a pressing need to reform the system of public sector pay determination (see below). The benchmarking exercise should be useful in this regard, but if it leads to large increases in public sector wages, offsetting measures may be needed. To promote employment, the net effect of household transfer and tax adjustments should increase the remuneration from working compared with nonparticipation or unemployment. Increased capital expenditures on physical infrastructure are clearly needed, but given the short-run capacity constraints in construction, prioritization is essential and all major projects should be subject to rigorous cost-benefit assessment. Greater temporary use of imported labor in public capital projects should also be pursued.

46. **The authorities' judgment that the present slowdown will not pose significant systemic difficulties for the banking system seems broadly appropriate, but vigilance is always essential on this score.** The banking system is well capitalized, and although the overall exposure to the real estate sector remains high, there is no evidence so far of a significant change in vulnerability since last year's FSAP. Staff welcomes the authorities' follow up on the recommendations of the FSAP and encourages the further strengthening of the supervisory framework by focusing on forward-looking assessments of systemic stability. The draft legislation establishing the single regulator should be approved quickly and a smooth transition ensured. The specialized personnel needed to strengthen insurance supervision should be increased without delay when the single regulator becomes operational at the beginning of next year. In view of the changing macroeconomic environment and the introduction of the single regulator, an update of the FSSA would be useful next year.

47. **To sustain high growth over the medium term, the authorities must begin now to address challenges with regard to wage determination, increasing competition, and strengthening the medium-term basis of fiscal policy.** Most importantly, as growth declines to more sustainable rates, labor markets must reflect this new reality. While wage growth in the private sector is disciplined by market forces, there is no such mechanism for the public sector. A key risk is that wages in this sector will overshoot levels conducive to continued rapid growth—with adverse signaling effects on private sector wages—or that labor unrest will increase out of a perception that workers are not getting a fair share of the gains from growth.

48. **A reform of the national partnership approach to sharpen focus and increase transparency would be helpful.** The broader social dialogue on such aspects as working conditions and job flexibility should continue. However, future agreements should be reformed to allow private sector wages to reflect market forces and for public sector pay to

be aligned with wages in comparable private sector jobs. Provided the comparators are chosen in an objective manner, the pay benchmarking exercise could form the basis of a comparator-driven system that allows for greater wage differentiation. Reform along these lines would preclude the trading of tax cuts and spending increases for promises of wage moderation.

49. **Strengthening competition through privatization and regulatory reform are not only key to securing a high rate of sustainable growth in the medium term, but would also increase discipline in public enterprise wage determination.** Some progress has been made in recent years, but there remains significant scope for further action in sectors traditionally characterized by public monopolies—such as utilities and mass transport—as well as in the retail food and beverage industries.

50. **A medium-term fiscal framework would clarify the authorities' public policy objectives and provide a measure of assurance that the public finances will be managed prudently on a sustained basis.** Explicit multi-year revenue plans and expenditure commitments—rather than incremental annual changes—would increase the transparency and predictability of fiscal policy. The allocation of increased public resources to specific sectors, such as health and education, should flow from a comprehensive analysis of alternative means to address public needs—including through greater private sector provision of these services. Medium-term budget plans should be complemented by mechanisms to hold spending departments publicly accountable for the delivery of agreed reforms and services within budget amounts. In order to identify areas where fiscal transparency can be further improved, staff encourages the authorities to undertake a Report on the Observance of Standards and Codes (ROSC) on fiscal transparency.

51. **Ireland's macroeconomic data are broadly adequate for conducting surveillance, but the authorities should, without delay, improve the coverage and timeliness of data necessary for monitoring short-term developments.** While data reporting has improved, significant gaps remain in the coverage and timeliness of key data such as wages, productivity, and balance sheets. The presentation of budget details could also be improved.

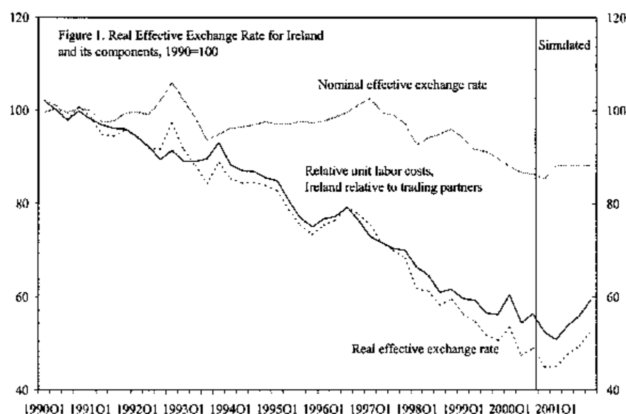
52. Staff encourages the authorities to make further progress towards achieving the U.N. target of 0.7 percent of GNP for official development assistance.

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

Box 1: Ireland: Wage Inflation and Competitiveness

The recent acceleration of Irish wages has raised concerns that labor costs could overshoot to levels that would seriously erode the external competitiveness of the Irish manufacturing sector. While some have been anxious about the rapidly increasing labor costs and, in a broader sense, the risk of overheating in a cyclically-advanced economy, others have argued that a rate of inflation that exceeds the EMU-average and declining competitiveness are a part of an equilibrating process through which rapidly growing economies adjust back to trend in a monetary union.[1] Higher wage and price inflation in Ireland could also reflect Balassa-Samuelson effects. This box analyses indicators of competitiveness assuming wage growth in Ireland of 10 percent and finds that at an aggregate level, the deterioration of competitiveness is not large when viewed against the sizeable gains over the past decade. However, for the indigenous sector, the deterioration in competitiveness would be greater given their more modest productivity gains. For these firms, a depreciated euro is an important factor in their ability to weather a 10 percent wage increase.

In the context of monetary union, the standard gauge of the competitive position of a country is the evolution of unit labor costs in relation to other members of the union.[2] Owing to very rapid overall productivity growth in manufacturing,[3] the Irish unit labor costs have been falling sharply for most of the 1990s and in 2000 despite the fact that the Irish wage inflation has already for some time outpaced the corresponding average rate in the EMU.[4] In the global context, the persistent depreciation of the euro against the dollar and the sterling has contributed to a fall in the real effective exchange rate and a continuously improving trend in competitiveness (Figure 1).



How would unit labor costs evolve assuming a 10 percent increase in manufacturing wages in 2001 and making some plausible projections about manufacturing output and employment? Assuming that productivity gains in manufacturing would remain favorable—albeit somewhat lower than during the latter half of 1990s—and that the euro does not appreciate sharply, the results suggest that a temporary acceleration in wage inflation would not hamper Ireland's competitive position significantly, but rather returns it to the levels that prevailed in 1999 (see Figure 1).[5] Thus, given the past decline in unit labor costs, a temporary rapid escalation of wages—even if accompanied by a modest fall in productivity growth—is unlikely to jeopardize Ireland's strong competitive position.

---

[1] See for example Blanchard, Olivier: "Country Adjustments within Euroland" , mimeo 2001, and *Selected Issues* paper for the 2001 Article IV consultation with the Netherlands, "Cyclically Advanced Euro-Area Economies—Consequences and Policy Options," (IMF Country Report 01/95), July 2001.

[2] No official unit wage cost data were available from the first quarter of 1999 onwards, and as there had been substantial revisions to manufacturing output data, revised estimates of unit wage costs needed to be constructed.

[3] Average growth in output per man-hour exceeded 9 percent in 1990-2000.

[4] Manufacturing wage data also excludes irregular bonuses that in certain sectors may play substantial role in compensation.

[5] Assumptions underlying the projection for 2001 are as follows: manufacturing output growth would slow to 13 percent (although no growth in output is assumed between Q4 2000 and Q4 2001, annual average growth would remain high due to very rapid expansion in the second half of 2000 and Q1 2001); employment would increase by 1.5 percent, average hours would remain at their current level; and wages would rise by 10 percent. This scenario would yield almost an 11 percent increase in output per man-hour, and thus despite the pick-up during 2001, the annual average of unit labor costs would fall slightly.

Measures of unit labor costs, however, overstate the degree of Irish competitiveness for the following reasons: (i) measured average productivity gains are, to large extent, attributable to the intangible foreign assets of multinationals. The strong average productivity gains do not result from superior marginal productivity of Irish labor that would push up wages and inflation (the Balassa-Samuelson effect), but rather from large global investments by multinationals in research, product development, and advertising.[6] (ii) Although representing a large share of the gross value added in Irish manufacturing, many of these highly productive multinational firms account for only a small share of total manufacturing employment; and wages represent only a very small fraction of their gross value added (Table 1). For example, in 2001, the "key sectors" in Table 1 represented only about 27 percent of manufacturing employment, although their share of value added was almost 63 percent. Thus, for a firm that has allocated large amounts of its resources to produce in Ireland, acceleration of wages of this magnitude may play only a partial role in its decision to continue to locate there.

For the mainly indigenous firms that represent the vast majority of manufacturing employment, however, a prolonged period of significant wage increases would be more problematic. Their profitability would decline relatively rapidly because their productivity gains have been far more modest and because their production is more labor-intensive. Furthermore, if the period of rapid wage increases would be accompanied by a sizeable appreciation of the euro, corresponding adjustment in real wages would be needed to avoid increases in unemployment. A corresponding scenario with a 10 percent increase in wages and its impact on real effective exchange rates for these non-key sectors is illustrated in Figure 2. The decomposition of the real effective exchange rate for these sectors suggests that a large part of the improved competitiveness is due to the depreciation of nominal effective rate and the strength of the sterling rather than the fall in relative unit labor costs. The dotted part of the real effective exchange rate lines, in turn, illustrates how competitiveness would be eroded under a pessimistic assumption that both the nominal exchange rate and manufacturing wages would rise by 10 percent 2001.

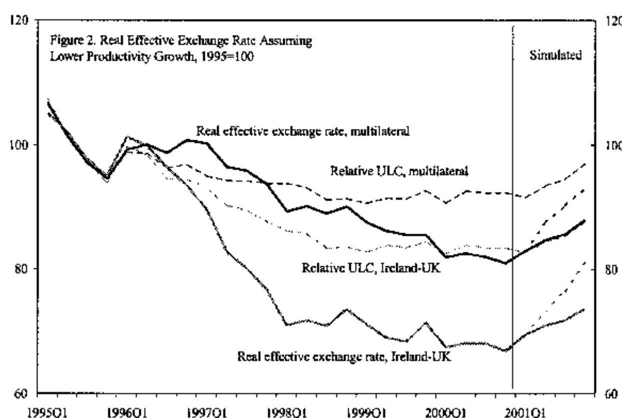


Table 1: Developments in Labor Productivity in 1995-2000

Industrial sector	NACE code	Average annual increase output	employment	average earnings	output per worker
Publishing, printing and reproduction of recorded media	22	12.2	6.5	5.5	5.4
Chemicals, chemical products and man-made fibres	24	27.1	5.4	4.7	20.5
Office machinery and computers	30	17.0	11.9	2.0	4.6
Key sectors	22, 24, 30	21.5	7.6	4.2	13.0
Key sectors excluding computers	22 and 24	23.4	5.9	5.1	16.6
Excluding key sectors		8.7	2.0	5.1	6.6
Manufacturing industries		15.8	3.3	4.9	12.1

Source: CSO and staff estimates

[6] One way to circumvent this problem would be to estimate productivity by isolating returns to intangible earnings, royalties, and other payments of subsidiaries to parent companies. These data are, however, available only on aggregate balance of payments basis, and thus the share of manufacturing industries could not be isolated. Another approach would be to exclude some of the sectors that are experiencing abnormal productivity compared with the global productivity of these sectors or by explicitly isolating these outlier sectors from the Irish manufacturing data. For detailed discussion see the *Selected Issues* paper for the 1999 Article IV consultation with Ireland, "Ireland and the Euro: Productivity Growth, Inflation, and the Real Exchange Rate" (IMF Staff Country Report 99/108), October 1999.

Box 2. Main Conclusions and Recommendations of the FSAP

Ireland participated in the Financial Sector Assessment Program during February-March 2000. The assessment took place against a background of strong asset price increases and credit growth as well as intensifying competition within the financial sector.

The FSSA found that Ireland had a highly developed financial system that had been remarkably stable, including in times of international financial turmoil. The system was supported by a regulatory framework that showed a very high degree of observance of applicable international standards and codes. The banking system had a strong capital base, significantly above the Basel minimum standards, an adequate liquidity base and, for most banks, a sufficiently high level of provision. The insurance industry, which was sizeable, was also very profitable and highly capitalized.

The following were the principal conclusions and recommendations of the final report.

- **The Central Bank of Ireland's (CBI) risk-based approach to supervision is adequate but could be further strengthened by an increased focus on systemic issues.** To that effect the CBI should deepen its analysis of data on macroprudential indicators, credit developments, and sectoral price trends (in particular overall and regional real estate transactions and price developments for commercial and residential real estate). For the CBI such information could facilitate a more in-depth view of the stability of the system as a whole, while permitting individual institutions to better react to global and regional market developments.

- **The prompt implementation of the decision to unify supervision is advisable.** It would help avoid opportunities for regulatory arbitrage, especially between securities and insurance. It would also end uncertainty about the future employment conditions of supervisors that makes recruitment of qualified staff more difficult.

- **In implementing banking supervision, the CBI should continue to pay particular attention to the smaller mortgage lenders.** While not individually systemically important, the sectoral concentration in loan portfolios of these institutions, along with their likely lower resilience, could lead to problems in case of an economic downturn which might be aggravated by a loss of reputation. In addressing the issue, the CBI should use its full arsenal of prudential requirements to ensure that these institutions are adequately capitalized and provisioned and move towards a necessary degree of portfolio diversification.

- **Some weaknesses in the area of insurance supervision require urgent attention.** Notwithstanding recent steps, further regulatory and supervisory action, preferably in the framework of the new supervisory agency, will be necessary to avoid doubts about the efficacy of insurance supervision.

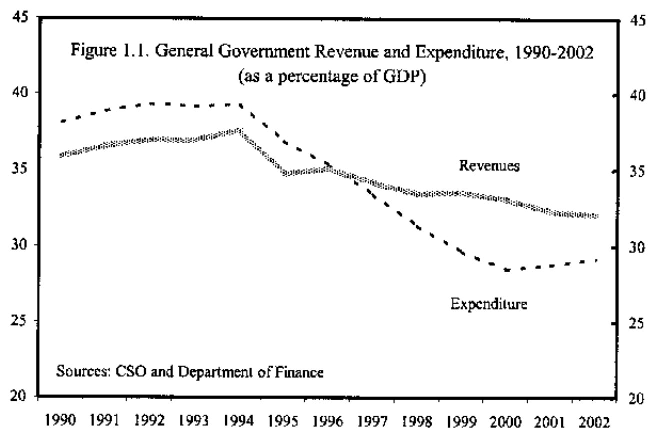
Supplementary Note 1: Fiscal Policy in Ireland

I. Introduction

1. The substantial structural changes and rapid economic growth that have taken place in Ireland over the past decade make the assessment of fiscal policy unusually difficult. This note (1) describes the evolution of fiscal policy over the last decade; and (2) estimates and interprets the current stance of fiscal policy. It finds that, although it is not possible to demonstrate a causal link, Ireland's tax and expenditure policies have been associated with impressive gains in labor force participation and economic growth. Moreover, although the cyclically adjusted fiscal surplus is estimated to decline by almost one percentage point of GDP in 2001, this easing follows a longer period of substantial tightening. Given this broader context and several other considerations outlined below, the fiscal impulse in 2001 is not likely to stimulate the economy significantly.

II. The evolution of discretionary fiscal policy

2. **The first-order effects of rapid economic growth were a reduction in the share of GDP devoted to interest payments, unemployment benefits and other social assistance.** By 1995, these effects manifested themselves in a rapidly falling ratio of total government expenditures to GDP and the start of a transition from deficit to surplus (Figure 1.1). In these dynamic circumstances, discretionary tax policy changes were necessary to avoid a tightening of the fiscal stance that, in the extreme, could threaten continued growth.



3. **The combination of rapid growth and a declining share of GDP going to government expenditures provided an opportunity to restructure fiscal policy to be consistent with the evolution to a smaller public sector.** The goals of the reforms were—and are—to promote economic growth, reward work and strengthen social solidarity. On the **expenditure side**, the primary changes were:

- a shift in emphasis in social programs from means-tested family benefits to universal child allowances, in order to promote labor force participation;
- increased spending on infrastructure to provide a foundation for continued growth;

- shift in responsibility for a variety of public services to the private sector, where competition can be promoted.

Reforms on the **revenue side** have been more profound, including:[1]

- phased reduction in the standard corporate tax rate from 43 percent in 1991, with the ultimate goal of unifying the tax rate on all corporate income at 12.5 percent;
- restructuring of the individual income tax structure to (1) reduce marginal rates; (2) widen tax rate bands; and (3) increase exemption amounts;
- "individualization" of income taxes to eliminate the marriage penalty on two-earner families;
- replacement of tax deductions with tax credits to equalize benefits across income levels;[2]
- plans for a comprehensive reform of the social insurance contribution scheme.

4. **To what extent were the reforms in fiscal policy simply facilitated by economic growth and to what extent did they contribute to it?** It is impossible to give a definitive answer to this fundamental question, but progress has been made toward each of the reform goals. Compared with ten years ago, seven percent more of the working age population is in the labor force and ten percent more of the labor force is employed. The expenditure-to-GDP ratio has fallen to less than 29 percent of GDP, despite the increase in capital spending. The revenue-to-GDP ratio also fell, but by much less, as growth mitigated the effect of the tax cuts on receipts. Compared with four years ago, the average tax rate on those still in the tax net has fallen on the order of 10 to 15 percentage points. At the same time, the share of income-earners exempt from taxes has increased from 26 to 38 percent, while the share facing the top marginal rate has fallen from 29 to 23 percent.[3] Despite these policies, however, the share of income taxes in GNP had recovered by 2000 after dipping in 1998-9 and is not projected to fall in 2001. As noted in paragraph 24 of the Staff Report, the ratio of corporate tax revenues to GDP has risen in the face of decreases in the average effective rate (see Figure 17).

5. **Not all of the discretionary actions were appropriate, however.** In particular, the recent elimination of the cap on wages subject to social insurance contributions undoes the marginal tax rate reductions on the highest-income wage earners. In addition, the VAT system would benefit from more uniformity. The current exempt and preferentially treated

---

[1] For a summary of tax major tax measures during 1990-2000, see the *Selected Issues* volume for the 2000 Article IV consultation with Ireland, "Fiscal Policy in Ireland: Trends and Prospects" (IMF Staff Country Report 00/99), August 2000.

[2] Both this reform and the new saving incentive scheme are hybrids of expenditure and revenue reforms, in that the benefits accrue even to those families that do not pay any taxes.

[3] These are estimates, as the tax cuts in 2001 account for a disproportionate share of these gains.

categories are designed to help lower income households, but a uniform rate with targeted or threshold assistance would be more efficient.[4] The new saving incentive scheme may be an expensive way to increase private saving.[5] Finally, more attention is needed on the quality of public expenditures, especially in health and education. The authorities' plans for a comprehensive review of the health care delivery system are a step in the right direction.

III. Quantitative Assessment of Current Fiscal Policy

6. **The quantitative assessment of fiscal policy derives from two building blocks, each of which is based on a set of assumptions and estimations.** First, a potential GDP series must be constructed.[6] Second, the effect of the differential between actual and potential GDP on government finances must be estimated. Each of these steps is fraught with uncertainty, especially in the case of Ireland given the rapid structural changes, the relatively elastic labor supply, and the very high rates of productivity growth associated with multinational activity.[7]

7. **Potential GDP and output gap.** Staff's estimates of potential GDP follow the standard production function approach. Labor input is defined as the product of labor force, the participation rate, the structural unemployment rate,[8] and hours worked. Capital input is assumed to be proportional to the capital stock, and changes in total factor productivity are calculated as the residual GDP growth that is not explained by increases in labor and capital inputs. Estimates for future labor input are based on medium-term projections of demographic changes, trends in participation rates and hours worked, as well as projections of the structural unemployment rate. The estimated NAWRU series, historical participation rate, and hours worked are smoothed using the Hodrick-Prescott filter to avoid erratic

---

[4] For instance, child and family allowances or some other refundable credit could be used to compensate poor families for the cost of a uniform VAT.

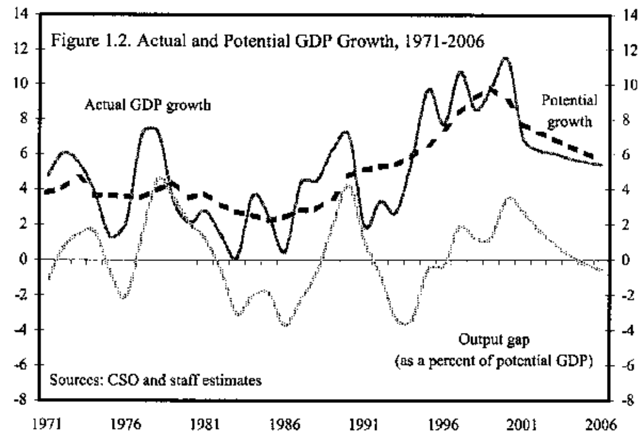
[5] See the symposium on "Government Incentives for Saving," *Journal of Economic Perspectives*, Fall 1996.

[6] Staff's concept of potential output corresponds to the level of GDP that can be achieved without creating an imbalance between demand and supply—leading, for instance, to accelerating price or wage inflation. Measurement of this level is difficult, however, especially in the case of the Irish economy, which has experienced a transition between stages of development. Furthermore, the linkages between changes in the rate of inflation and unemployment have been weak due to the size and openness of the Irish economy.

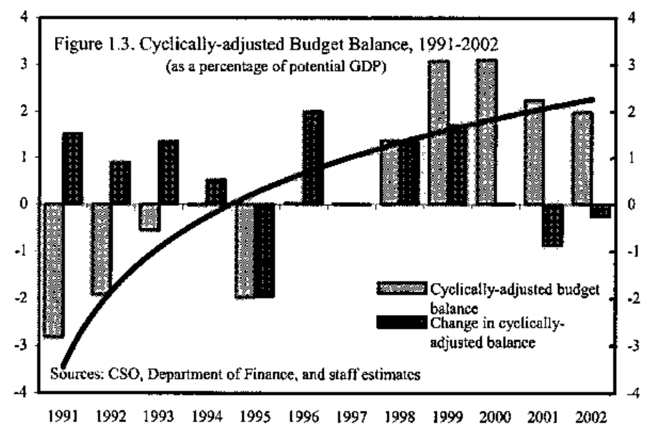
[7] For further discussion of these issues, see the *Selected Issues* volume for the 1999 Article IV Consultation with Ireland, "Potential Output Growth in Ireland" (IMF Staff Country Report 99/108), October 1999.

[8] The structural unemployment rate or NAWRU—the non-accelerating wage (inflation) rate of unemployment—is defined as the share of the labor force that must be unemployed to avoid accelerating wage inflation. Given its openness, the wage-based NAWRU is more appropriate for Ireland than the usual CPI-based NAIRU. For a detailed discussion of this methodology see Giorno et al., "Estimating Potential Output, Output Gaps and Structural Budget Balances," OECD Working Paper 152, 1995. The estimated NAWRU, smoothed to avoid erratic movements, closely parallels the actual unemployment rate, smoothed in the same manner. If the smoothed unemployment rate is substituted for the smoothed NAWRU in the calculation of potential output—yielding an alternative series more appropriately viewed as trend output—the estimate of fiscal stance (rounded to a tenth of a percent of GDP) is identical over the entire period for which it is calculated (1991-2006). This is not surprising, since the correlation between the two series is 0.995.

movements. These series are then projected through 2006 assuming a gradual convergence to their estimated long-run levels. The capital stock is also assumed to converge gradually towards the level derived from the staff's estimates of investment growth through the end of the forecast period. The actual and projected input series are then combined—assuming that total factor productivity returns gradually to its long-run average by the end of forecast horizon—to calculate potential output. Finally, the output gap is calculated as the difference between actual and potential output (Figure 1.2).



8. **Fiscal stance.** To estimate the cyclically-adjusted budget balance—that is, the balance that would prevail if actual GDP were equal to its potential—revenue is adjusted by applying a tax elasticity to the output gap. For outlays, unemployment benefits are adjusted for the difference between actual and structural unemployment. The upward trend in the cyclically-adjusted budget balance (Figure 1.3) is quite pronounced, with large surpluses emerging in recent years. The estimated balances also imply a substantial tightening of fiscal policy in the periods 1991 to 1994 and 1996 to 2000, followed by a somewhat looser stance in 2001-2 (equivalent to a cumulative expansionary fiscal impulse of about 1 percent of GDP). The cyclically-adjusted primary balances tell a similar, though much less striking story.



9. **There are a number of important factors that should be considered in evaluating the current fiscal stance in Ireland**:

- First, estimates of the fiscal stance for recent years are sensitive to whether the input series are smoothed and, if so, the end-point chosen. Using the same underlying data, but including future projections and smoothing the series through 2006, yields somewhat lower estimates for trend growth over the 1997-2001 period and, consequently, a larger positive output gap by 2000 (that is more than reversed by 2006). Estimates of fiscal stance for 2001 would be 0.1 percent of GDP tighter with smoothing through 2006. Alternatively, if the series were smoothed only through 2003, the fiscal stance in 2001 would be 0.2 percent of GDP tighter.

- Second, given the weaker-than-anticipated revenue outturn thus far, staff's estimate of revenue in 2001 is significantly lower than that of the authorities. This partly reflects the apparent basing of the 2001 budget revenue projection on the exceptionally high level of automobile sales last year. To the extent that automobile sales in 2000 represented a shift in planned purchases from 2001 to 2000, the cyclically-adjusted estimates may overstate the decline in structural revenues and the structural overall balance in 2001, and vice versa in 2000.

- Third, the macroeconomic effect of the fiscal stance depends on characteristics of the economy, such as the degree of openness and the private sector's reaction to changes in government saving. Fiscal policy in Ireland would tend have a smaller impact on aggregate demand given the openness of the economy and the tendency for private saving to offset—at least partially—changes in government saving.[9] Even in the absence of Ricardian effects, several of the budget measures should elicit responses that will partly offset the estimated fiscal stimulus. In particular, the outlays for the new tax preferred saving scheme will be—at least partly—offset by increased private saving. The tax rate reductions, rate band broadening, and the "individualization" of taxes for two-worker couples should help promote work by mitigating tax distortion of labor supply decisions. Finally, the share of gross public capital formation—which, properly measured, is government saving—has increased substantially in recent years, from 2.3 percent in 1995 to an average of almost 4 percent of GDP in 2000.

- Fourth, real growth in the Irish economy has averaged almost 8 percent per year since 1990. From 1991 to 1999, the fiscal stance was tightened by a cumulative 7.4 percent of GDP. Even with the loosening in 2001, fiscal policy has been generally tight for a decade.

10. In **summary,** staff's cyclical adjustments imply a 0.9 percentage point of GDP fiscal loosening in 2001. Although fiscal policy should have been neutral this year, the effective stimulus is unlikely to be large, especially given the broader context described above.

---

[9] In a cross-country setting, Thomas (2001), for instance, finds that the intergenerational fiscal position, the size of the fiscal adjustment, and the degree of openness influence the extent to which changes in government revenue affect total saving in the economy. In particular, with Ireland being a country in rough intergenerational balance, tax cuts there are found to be offset by comparable increases in private saving. Alun Thomas, "An Exploration of the Private Sector Response to Changes in Government Saving Across OECD Countries," *IMF Working Paper* WP/01/69.

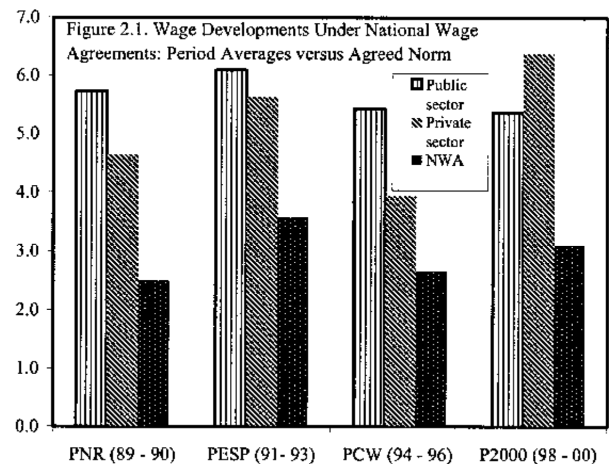
Supplementary Note 2: Incomes Policies

I. Introduction

1. **Centralized wage bargaining has a long history in Ireland.** When national pay agreements failed to tame industrial unrest or prevent wage inflation during the 1970s, decentralized negotiations returned to favor in 1981. By 1987, the rapid and steep economic decline created a national sense of shared crisis, requiring a new social consensus to lift the country from its malaise. The tripartite partnership—labor, business and government (both as an employer *per se* and as policy maker)—was reborn with the first of five national wage agreements (NWA), each covering a period of approximately three years.[1] This note reviews briefly the experience under the NWAs, including some emerging deficiencies, and discusses some options for moving forward with future agreements.

II. National Wage Agreements During the 1990s

2. **The multi-year NWAs, founded on a spirit of social consensus, have been the cornerstones of the Irish strategy to secure wage moderation and employment growth.** The partnership approach has potential advantages over decentralized bargaining by: (i) fostering social consensus; (ii) providing a benchmark for wage expectations; and (iii) providing guideposts for wage growth in sectors in which productivity improvements are difficult to measure (e.g., the public sector) or in which competitive pressures are absent or weak (e.g., natural monopolies or protected network sectors). Under the agreements, workers have committed to limit wage demands in exchange for tax reductions and social policies that reduce social exclusion. Pre-specified annual pay "norms" for the period covered by the agreement consist of maximum annual percentage increases in nominal base wages together with minimum fixed weekly hourly wage increases for the lowest paid. The range of bargaining issues has been broadened with each agreement.



Source: OECD; CSO; and staff estimates.

3. **Conditions during the early years of the expansion were favorable to a return to centralized agreements**: reducing the unemployment rate from double digits was widely and rightly perceived as a high priority; the tax burden was sufficiently high to warrant tax cuts on efficiency grounds; and the fortuitously favorable external environment helped initiate a

[1] These agreements were: (i) 1987-90: the Programme for National Recovery (PNR); (ii) 1991-93: the Programme for Economic and Social Progress (PESP); (iii) 1994-96: the Programme for Competitiveness and Work (PCW); (iv) 1997-early 2000: the Partnership for Inclusion, Employment and Competitiveness (P2000); and (v) 2000-03: the Programme for Prosperity and Fairness (PPF).

'virtuous circle' of rapid economic growth that facilitated successor agreements. Wage growth, in fact, exceeded the norms agreed under all NWAs (see Figure 2.1), but these excesses did not jeopardize Irish competitiveness because of substantial productivity gains (see Box 1). Given the very rapid growth of the economy, exceptional revenue growth enabled the government to deliver the budgetary concessions needed to "buy" wage moderation. Moreover, as long as there was sufficient slack in the labor market, reductions in marginal tax rates helped boost female labor force participation, fueling the virtuous circle further.[2]

III. Emerging Deficiencies

4. **As the economic expansion has matured, however, a number of drawbacks to the existing partnership approach have emerged.** First, as the labor market tightens, agreements may become less effective in restraining wage growth to rates justified by productivity gains, and the wage norms may begin to set a minimum rate of increase rather than a maximum. Second, with their focus on a single wage norm, the agreements have tended to discourage the wage dispersion necessary for an efficient allocation of labor. Third, by limiting wage dispersion, the agreements may have contributed to wage growth lagging productivity gains, notably in some sectors.[3] Fourth, the agreements have been less successful recently than in the early 1990s in preventing industrial unrest. During the late 1990's, some groups of workers (e.g., police and nurses) have obtained specific pay increases substantially more than allowed under the NWA, creating a risk of "leap frogging" pay demands. Similarly, in early 2001, secondary school teachers made—thus far unsuccessfully—similar demands. Fifth, the trading of tax cuts and spending increases for wage moderation tends to impart a pro-cyclical bias to fiscal policy.

IV. The Way Forward

5. **There is general support in Ireland for retaining the partnership approach in broad terms, albeit little consensus yet on how to structure future agreements.** Several key weaknesses will clearly have to be addressed. **First, the practice of trading-off of tax cuts for wage moderation should be stopped,** as tightening labor markets, other things equal, will increase the pro-cyclical effects of trading tax cuts for wage moderation when growth is above trend. In addition, real public spending cannot decline forever as a share of GDP (general government spending fell from 35.4 percent of GDP in 1996 to 28.5 percent in 2000), reducing the scope for future tax cuts.

---

[2] There is solid empirical evidence that changes in marginal income tax rates can have a strong effect on female labor supply, and that this effect is greater than for males. The response arises at the *extensive* margin, that is, at the decision whether to enter or not the labor force. Given the generally higher labor force participation of men, the estimated weak male labor supply response to taxes is explained by the fact that taxes have limited effects at the *intensive* margin, that is, the decision to work an additional unit of time or not. (See James J. Heckman, "What Has Been Learned About Labor Supply in the Past Twenty Years," *The American Economic Review,* Volume 83, Issue 2, Papers and Proceedings (May 1993)). These findings are relevant to explaining in part the rapid growth in labor supply in Ireland during the 1990s; the female labor force participation rate increased from 39.7 percent in 1995 to 47.9 percent at end 2000 (as a percent of the population aged 15 and over).

[3] For instance, P2000 called for nominal wage increases of 1 percent in 1999, a year in which real GDP growth surged to about 10 percent.

6. **Second, given Ireland's openness and, in particular, its participation in EMU, wage flexibility is especially important to ensure the country remains competitive and adaptable to external shocks.** This, in turn, will require that future agreements allow wage increases to vary by sector and occupation, to ensure that workers migrate to their most productive uses. In addition, wage flexibility will be an important factor determining the speed and cost at which the economy adjusts to a negative external shock. Privatization and deregulation are natural complements to social partnership to the extent that they bring market pressures to bear in wage determination in sheltered sectors and traditional public monopolies.

7. **Third, in the public sector, where productivity is inherently more difficult to measure and market forces cannot be brought to bear with much immediacy, future agreements will have to ensure the maintenance of comparability with the private sector.** The ongoing benchmarking exercise is a vital first step, but this will have to be followed by a more permanent comparator based system for determining public sector pay increases. Given the need for greater wage differentiation, an aspect of the partnership that will most need to change is the establishment of a single norm for all workers.

8. **There is ongoing debate in Ireland over how the partnerships approach can be reformed.** ESRI recently published two proposals for modifying the wage-setting process. McHale (2001) has proposed a deferred compensation scheme designed, among other things, to limit the pro-cyclical effects of exchanging tax cuts for wage moderation.[4] This scheme would consist of the establishment of Universal Personal Retirement Accounts to which both workers and the government (rather than provide current tax cuts) would contribute. Although the rational forward-looking consumer is recognized to be indifferent between current and deferred compensation of equal present value, the author argues that borrowing constraints should reduce the marginal propensity to consume out of deferred income relative to that out of current income. An alternative is suggested by Buitleir and Thornhill (2001). The authors propose a complex "gain sharing" mechanism for the public sector (which they consider extendable to the private sector). The scheme would consist of the creation by the Exchequer of a *growth fund* from which growth dividend payments would be made. Financial provisions for the fund in any fiscal year would be based on a projection of GNP/worker for the economy as a whole, but disbursements of the growth dividend would occur with a long enough lag to confirm the outturn of GNP/worker.[5] Both these alternatives would involve a significant degree of administrative complexity and neither addresses the problems inherent in a single national norm. The Buitleir and Thornhill scheme does emphasize the role of productivity in setting compensation, but only in an aggregate manner. Some form of firm-specific profit sharing could more effectively tighten the linkage between compensation and productivity improvements. However, given the openness of the Irish economy to international competition, it is difficult to see how, as the economy reaches full employment, private sector wages could consistently resist being market determined.

---

[4] John McHale, "Adding an Instrument to Social Partnership: A Proposal for Deferred Compensation," in *Quarterly Economic Commentary,* The Economic and Social Research Institute, March 2001.

[5] Donal de Buitleir and Don Thornhill, "A Mechanism for Sharing the Fruits of Growth," in *Quarterly Economic Commentary,* The Economic and Social Research Institute, March 2001.

Table 1. Ireland: Selected Economic Indicators

(annual change unless otherwise stated)

	1996	1997	1998	1999	2000 Prel.	2001 Proj.	2002 Proj.
National accounts (constant prices) 1/							
GNP	7.4	9.3	7.8	7.8	9.8	6.3	5.6
Net foreign balance 2/	0.1	0.0	-2.4	1.7	0.1	-1.8	-0.8
GDP	7.7	10.7	8.6	9.8	11.5	7.0	6.2
Domestic demand	7.8	9.8	9.4	6.3	9.9	6.2	6.3
Private consumption	6.3	7.4	7.8	7.7	9.2	7.2	6.2
Public consumption	3.1	5.7	5.1	5.2	6.1	5.0	4.5
Gross fixed investment	16.1	19.8	16.0	13.0	10.4	6.5	7.5
Exports of goods and services	12.2	17.4	21.4	12.4	19.4	9.5	10.5
Imports of goods and services	12.5	16.8	25.8	8.7	18.9	10.5	11.3
Prices, wages and employment							
Consumer prices (annual average)	1.6	1.5	2.4	1.6	5.6	4.5	3.5
Consumer prices (end of period)	...	...	...	1.7	5.9	...	...
Harmonized Index of Consumer Prices (annual average)	...	2.1	1.2	2.2	5.2	4.2	3.6
Average hourly earnings , manufacturing	2.8	3.1	5.0	5.6	6.2	...	...
Output, manufacturing	8.4	19.4	21.3	15.0	15.7	...	...
Unit wage costs (manufacturing)	-0.3	-8.3	-11.7	-8.7	-3.8 3/	...	...
GNP/Employment	3.6	5.3	-0.5	1.4	4.9 4/	3.3	3.5
Employment	3.7	3.8	8.3	6.3	4.7 4/	2.9	2.0
Unemployment rate (in percent)	11.5	9.8	7.4	5.6	4.3	3.7	3.8
Money and credit (end-period)							
M3E 5/	15.7	19.1	18.1	...	14.7	...	...
Private sector credit 6/	29.6	22.6	22.6	33.5	20.6	...	...
Public finance (In percent of GDP)							
General Government Balance 7/	-0.2	0.7	2.1	3.9	4.6	3.5	2.9
Primary balance 7/	3.7	4.3	4.9	5.8	6.1	4.8	3.8
General government debt	74.3	65.1	55.0	50.1	39.3	33.8	28.3
External trade and balance of payments							
Merchandise export volume	11.5	17.6	22.0	12.4	20.5	9.8	10.5
Merchandise import volume	11.0	15.0	23.0	8.5	19.5	10.0	10.7
Terms of trade	0.2	0.5	0.4	-0.4	-2.6	...	...
Balance of goods and services (Percent of GDP)	11.6	12.7	11.4	13.7	13.0	12.4	11.7
Current account (Percent of GDP)	3.5	3.1	0.9	0.6	-0.9	-1.8	-2.6
Official reserves (In billions of SDRs, end of period.)	5.7	4.8	6.7	3.9	4.1	...	...
Effective exchange rates (1996=100, annual average)							
Nominal	100.0	100.4	95.3	92.2	86.6	87.4 8/	...
Real (CPI based)	100.0	99.7	95.3	92.4	89.5	91.9 8/	...

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

1/ Based on National Income and Expenditure, compiled in accordance with the new European System of National Accounts (ESA 95).

2/ Contribution of net exports and net factor incomes to GNP growth.

3/ Staff estimates. Underlying productivity growth data may be overstated because of problems related to the measurement of output produced by multinational companies operating in Ireland. Official unit wage data has not been published since Q1 1999.

4/ Data prior to 1999 based on data from the second quarter of the year and annual average since then. There was break in series that affects the growth rate in 1998.

5/ M3E was discontinued in December 1998. The methodology for calculation of Ireland's contribution to the Euro area money supply was amended in January 2000.

6/ Headline change, which includes the effects of transactions between credit institutions and non-bank international financial companies.

7/ Estimated prior to allocations for financing of future pensions liabilities and one-off expenditures, but including contingency provision for 2002.

8/ End-April 2001.

Table 2. Ireland: Summary of Balance of Payments
(In percent of GDP)

	1996	1997	1998	1999	2000	2001 proj.	2002 proj.
Current account balance	3.5	3.1	0.9	0.6	-0.9	-1.8	-2.6
Trade balance	19.2	21.0	23.1	25.9	27.3	26.8	26.6
Exports of goods	67.3	69.2	71.9	71.8	78.3	77.6	78.9
Imports of goods	-48.1	-48.2	-48.8	-45.9	-51.0	-50.9	-52.3
Services	-7.5	-8.3	-11.7	-12.2	-14.3	-14.3	-14.9
Credit	10.4	10.6	14.6	15.8	16.1	16.0	16.3
Debit	-17.9	-18.9	-26.3	-28.0	-30.4	-30.3	-31.2
of which Royalties	-4.5	-5.0	-6.9	-7.0	-7.4	...	...
Credit	0.1	0.1	0.2	0.4	0.5	...	...
Debit	-4.7	-5.1	-7.1	-7.4	-7.9	...	...
Balance on goods and services	11.6	12.7	11.4	13.7	13.0	12.4	11.7
Factor incomes	-11.1	-12.0	-12.2	-14.5	-14.9	-14.9	-14.8
Credit	7.8	9.3	23.2	26.8	32.5	...	...
Debit	-18.9	-21.3	-35.4	-41.3	-47.4	...	...
Balance on goods, services and income	0.5	0.7	-0.8	-0.7	-1.9	-2.5	-3.2
Current transfers (net)	3.0	2.4	1.7	1.4	1.0	0.7	0.6
Capital and financial account			2.6	0.8	7.5	...	...
Capital Account Balance			1.1	0.6	1.2	...	...
Financial Account			1.5	0.2	6.3	...	...
Direct investment			5.7	14.5	19.2	...	...
Portfolio investment			-11.0	-16.0	0.0	...	...
Other investment			9.7	-0.3	-12.9	...	...
Reserve Assets			-3.0	2.0	-0.1		
Net residual			3.5	1.5	6.7	...	...

Sources: The Central Statistics Office and staff estimates.

Table 5. Ireland: General Government Finances
(In percent of GDP)

	1996	1997	1998	1999	2000	Proj. 2001	Official 2001 1/
Current surplus:	1.4	2.4	3.8	6.0	7.4	6.3	7.0
Current revenue, of which	35.1	34.2	33.4	33.5	33.1	32.3	32.7
Tax revenue	28.5	28.0	27.6	27.6	27.0	26.3	26.7
Social security receipts	4.4	4.1	4.0	4.2	4.3	4.1	4.1
Miscellaneous	2.2	2.0	1.8	1.7	1.8	1.9	1.8
Current Expenditure, of which	33.8	31.8	29.6	27.6	25.7	26.0	25.7
Interest payments	4.7	4.2	3.4	2.4	2.1	1.9	1.8
Goods and services	3.9	3.8	3.8	3.8	3.4	3.5	3.4
Compensation of employees	9.6	9.2	8.8	8.4	8.0	8.2	8.1
Transfers	14.8	13.8	13.0	12.3	11.5	11.9	11.8
Other	0.8	0.8	0.7	0.7	0.6	0.6	0.6
Current expenditure, excluding interest and transfers	14.3	13.7	13.2	12.8	12.0	12.2	12.1
Capital deficit	1.6	1.7	1.7	3.9	2.8	2.8	2.7
Gross capital formation	2.3	2.5	2.7	3.1	3.9	4.4	4.3
Net capital transfers 2/	-0.7	-0.8	-1.0	0.7	-1.0	-1.6	-1.6
General government balance 3/	-0.2	0.7	2.1	3.9	4.6	3.5	4.3
Net interest	-3.9	-3.5	-2.8	-1.9	-1.6	-1.3	-1.3
Primary balance	3.7	4.3	4.9	5.8	6.1	4.8	5.6
Memorandum items:							
Cyclically adjusted (as a percent of potential GDP):							
Revenue	35.1	34.1	33.4	33.5	33.0	32.2	33.0
Expenditure, of which	35.1	34.1	32.0	30.4	29.9	30.0	30.0
unemployment benefits	2.1	1.8	1.7	1.4	1.1	1.0	1.0
Government balance	0.0	0.0	1.4	3.1	3.1	2.2	3.0
Primary balance	3.9	3.5	4.2	5.0	4.7	3.6	4.4
Growth in nominal GDP	10.2	15.6	14.8	14.0	16.2	12.9	13.8

Sources: Department of Finance and staff estimates.

1/ Projections based on Budget 2001 and revised estimates from March 2001. Cyclically-adjusted numbers are based on the staff's methodology and estimates of structural unemployment and unemployment benefits, but on the authorities' estimates of revenue and expenditure.
2/ Net capital transfers were affected by the repayment of the government's pension liabilities with respect to An Post and Telecom Eireann of 1.8 percent of GDP in 1999.
3/ In 1999 the overall balance was 2.1 percent of GDP and the primary balance 4 percent of GDP when a set aside of 1.8 percent of GDP to meet future pension liabilities is taken into account.

Table 6. Ireland: Stability Program (2001-2003)

	2000	2001	2002	2003
	Fiscal Projections 1/ (As a percent of GDP)			
Current surplus:	7.4	7.0	8.0	9.2
Current revenue	33.3	32.5	32.5	32.7
of which:				
Tax revenue	27.2	26.6	26.6	26.8
Social Security Receipts	4.2	4.1	4.3	4.3
Miscellaneous	1.8	1.8	1.7	1.6
Current expenditure	25.9	25.4	24.5	23.5
of which:				
Interest payments	2.0	1.8	1.4	1.2
Goods and services	12.3	12.1	12.2	12.0
Other transfers	11.5	11.5	10.9	10.4
Capital deficit	-2.7	-2.8	-3.8	-3.7
Government investment	-5.1	-5.4	-5.5	-4.9
Capital resources	2.4	2.6	1.7	1.1
General government surplus				
before contingency	4.7	4.3	4.2	5.4
Contingency	...	...	-0.4	-0.8
General government surplus				
after contingency	4.7	4.3	3.8	4.6
of which primary surplus	6.7	6.1	5.4	6.0
General government debt	39	33	28	24
	Cyclically Adjusted Budget (In percent of potential GDP)			
Potential GDP 2/	8.1	7.9	7.7	7.4
Output gap	4.5	5.4	4.0	2.4
Cyclically adjusted fiscal balance				
before contingency	3.6	2.9	3.1	4.8
after contingency	3.6	2.9	2.7	4.0
Memorandum items:				
GDP	10.7	8.8	6.3	5.7
GNP	8.6	7.4	5.4	5.1
Consumer prices	5.5	4.5	3.5	2.5
Employment	4.5	3.5	2.1	1.8
Unemployment rate	4.1	3.2	3.2	3.2

Source: Department of Finance.

1/ Fiscal projections are reported on ESA95 basis and were presented at the time of the 2001 budget.
2/ As presented in the Stability Program (annual change in percent).

Table 9. Ireland: Indicators of External and Financial Vulnerability
(In percent of GDP, unless otherwise indicated)

	1996	1997	1998	1999	2000	2001 Latest estimate	Date
External indicators							
Exports (annual percent change, in U.S. dollars)	11.7	12.7	16.8	9.6	8.5	...	
Imports (annual percent change, in U.S. dollars)	11.7	11.5	20.5	6.5	10.9	...	
Terms of trade (annual percent change)	0.2	0.5	0.4	-0.4	-2.6	...	
Current account balance 1/	3.5	3.1	0.9	0.6	-0.9	...	
Capital and financial account balance, 1/	-2.6	-7.3	2.6	0.8	7.5	...	
Of which:							
Inward portfolio investment	...	...	50.0	72.6	83.0	...	
Inward foreign direct investment	...	...	9.9	20.3	22.1	...	
Other investment liabilities (net)	...	...	9.7	-0.3	-12.9	...	
Official reserves (In U.S. dollars, billions)	7.9	7.0	9.2	5.7	5.4	5.3	May
Broad money to reserves ratio 2/	7.0	9.1	7.7	17.0	18.0	18.6	May
Central bank foreign liabilities (in billions of U.S. dollars) 3/	...	...	...	1.5	0.6	0.2	May
Foreign assets of the financial sector (in billions of U.S. dollars)	68.0	109.0	137.9	177.4	184.5	...	
Foreign liabilities of the financial sector (in billions of U.S. dollars)	73.3	113.8	148.0	187.3	192.3	...	
Total external debt 4/	19.1	15.7	12.2	2.9	2.1	...	
Of which:							
External debt to exports ratio	24.6	19.7	14.0	3.3	2.2	...	
External interest payments to exports (in percent)	1.9	2.0	1.0	0.2	...	...	
Irish pound against U.S. dollar (period average)	1.60	1.52	1.43	1.35	1.17	1.08	June 29
Financial Markets Indicators							
General government debt	74.3	65.1	55.0	50.1	39.3	...	
Government bond yield (10 years to maturity, end-period)	6.58	5.48	3.99	5.60	5.07	5.3	June 29
Government bond yield (real, 10 years to maturity)	4.98	3.98	1.59	4.00	-0.53	-0.32	
Annual change in stock market index (percent, end of period)	22.1	48.7	23.2	0.4	18.0	7.8	April
Spread of government bond yield with Germany (end of period)	0.90	0.21	0.18	0.25	0.17	0.21	June 29
Financial Sector Risk Indicators							
Personal lending as a share of total loans (excluding financial intermediation)							
House mortgage finance	41.7	41.8	40.7	39.7	39.0	38.9	March
Other housing finance	0.6	1.0	1.0	0.9	1.0	0.9	March
Other personal lending	12.3	13.1	12.4	13.0	12.2	12.5	March
Commercial property lending as a percent of total loans (excluding financial intermediation) 5/	11.2	11.9	12.0	18.2	20.5	20.6	March
Off-balance sheet business (as a percent of regulatory capital)							
Excluding OTC derivatives	80.3	83.0	75.3	87.1	97.5	...	
Including OTC derivatives	126.2	106.1	104.0	119.7	121.7	...	
Non-performing loans/loans to private sector (in percent) 6/	...	2.8	2.5	1.8	1.9	...	
Total capital/Risk-weighted assets (in percent)	13.6	13.0	14.0	13.7	13.7	...	
Deposits to M3 ratio 7/	...	...	...	1.026	1.034	...	
Loan-to-deposit ratio vis-à-vis Irish residents 8/	...	...	...	1.291	1.361	...	
vis-à-vis total 8/	...	...	...	1.481	1.551	...	
Concentration ratios in the banking sector							
No. of banks accounting for 25% of total assets	...	...	3	3	3	...	
No. of banks accounting for 75% of total assets	...	...	23	23	24	...	

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

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

Ireland: Basic Data

Demographic and other data for 2000:

Area:	70.3 thousand square kilometers
Population (in million)	3.8
Natural rate of increase (percent change)	0.6 percent
Infant mortality	0.59 percent
Population per physician	633
GDP per capita (SDR)	18,852

Composition of GDP in 2000 at current prices	In millions of Irish pounds	Distribution in percent
Private consumption	40,231	50.1
Public consumption	9,917	12.4
Total investment (including stockbuilding)	19,650	24.5
Total domestic demand	69,798	87.0
Exports of goods and services	75,746	94.4
Imports of goods and services	65,299	81.4
GDP at market prices (expenditure estimate)	80,245	100.0

Selected economic data	1998	1999	2000
	(Annual percentage change)		
Output and unemployment:			
Real GDP (expenditure estimate)	8.6	9.8	11.5
Manufacturing production	21.3	15.0	15.7
Average unemployment (in percent)	7.4	5.6	4.3
Earnings and prices:			
Average earnings in manufacturing	5.0	5.6	6.2
Consumer price index	2.4	1.6	5.6
Money and interest rates (end period)			
M3E	18.1	...	14.7
3-month Interbank rate	3.2	3.3	4.8
10-year government bond yield	4.0	5.6	5.1
Fiscal accounts:	(In millions of Irish pounds)		
General government receipts	20,255	23,157	26,535
General government expenditure	18,998	21,705	22,869
Balance of payments			
Current account balance	556	445	-683
in percent of GDP	0.9	0.6	-0.9
Trade balance	13,996	17,903	21,900
Exports	43,532	49,579	62,807
Imports	-29,536	-31,676	-40,907
Services, incomes and transfers (net)	-13,440	-17,458	-22,583
Capital and financial account	1,555	562	6,029
Gross reserves			
(billions of SDR, end of period)	6.7	3.9	4.1

Sources: National Income and Expenditure; Balance of International Payments; and staff estimates.

Ireland: Fund Relations

(As of May 31, 2001)

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

II. **General Resources Account:**	**SDR Million**	**% Quota**
Quota	838.40	100.0
Fund holdings of currency	584.14	69.7
Reserve position in Fund	254.28	30.3

III. **SDR Department:**	**SDR Million**	**% Allocation**
Net cumulative allocation	87.26	100.0
Holdings	40.60	46.5

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

V. **Financial Arrangements:** None

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

VII. **Exchange Arrangement**

As of January 1, 1999, the euro became the currency of Ireland; the irrevocably fixed conversion rate between the euro and the Irish pound is 0.787564. The legal tender status is planned to be withdrawn from Irish notes and coins on February 9, 2002. In accordance with UN Security Council resolutions and EU regulations, Ireland maintains restrictions on payments and transfers with Iraq and Unita movement in Angola.

VIII. **Article IV Consultations**

The discussions for the last Article IV consultation were conducted in Dublin during May 5-15, 2000. The staff report (SM/00/163) was considered by the Executive Board on August 2, 2000 (EBM/00/80). Article IV consultations with Ireland are currently on the standard 12-month cycle.

IX. **Technical Assistance:** None

X. **Resident Representative:** None

Statistical Annex

Ireland is subject to the statistical requirements, timeliness, and reporting standards of Eurostat and the European System of Central Banks (ESCB). Ireland has cooperated with the IMF in providing monetary, international reserves, and other financial statistics related to its membership in the European Economic and Monetary Union (EMU). These data are considered reliable and well documented. The frequency and timeliness of the publication of the core statistical indicators are summarized in the attached table.

1. Ireland has subscribed to the Fund's Special Data Dissemination Standard (SDDS), and its metadata are posted on the DSBB. In order to meet the SDDS requirements, Ireland has improved the timeliness of the industrial production index and merchandise data and therefore avails itself of special flexibility for the timeliness of national accounts and balance of payments data, respectively. The latter are presently being disseminated six and four months after their reference periods. The Irish authorities adopted the 1993 System of National Accounts (SNA) in 1999, and launched the publication of quarterly national accounts in September 1999.

2. The publication of balance of payments statistics has been improved as information on the capital account is fully consistent with the fifth edition of the Balance of Payments Manual. Historical data, however, cover only years starting from 1998.

3. While lags in publishing some key indicators, such as trade volumes and industrial production, have declined considerably, there still exist substantial lags in the publication of others. For example, earnings data are typically published with lags of 5 to 15 months, depending on the sector, and no overall wage index is available. Also, manufacturing productivity and unit wage cost data have been discontinued as of the first quarter of 1999. Data on household and corporate balance sheets are not yet available, but the Central Statistical Office is currently compiling national financial accounts for Ireland.

Ireland: Core Statistical Indicators
(As of June 29, 2001)

	Exchange Rates	International Reserves	Central Bank Balance Sheet	Reserve/ Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Govern-ment Balance	External (Non-euro denominatead) Debt/Debt Service	GDP/ GNP
Date of Latest Observation	6/18/2001	Apr. 2001	May 2001	Apr. 2001	Apr. 2001	6/18/2001	May. 2001	Mar. 2000	4th quarter 2000	2000	2000	3rd quarter 2000
Date Receive	6/18/2001	June 2001	June 2001	June 2001	June 2001	6/18/2001	6/8/2001	5/30/2001	4/19/2001	March 1, 2001	April 2001	April 2001
Frequency of Data	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Quarterly	Annual	Quarterly	Quarterly
Frequency of Reporting	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Quarterly	Annual	Quarterly	Quarterly
Source of Update	Commercial	Central Bank	Central Bank	Central Bank	Central Bank	Commercial	CSO	CSO	CSO	Dept. of Finance	Central Bank	CSO
Monthly Reporting	Internet	Internet	Internet	Internet	Internet	Internet	Internet / Diskette/ Publication	Internet / Diskette/ Publication	Internet / Diskette/ Publication	Internet	Internet/ Publication	Internet/ Diskette/ Publication
Confidentiality	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public
Frequency of Publication	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Quarterly	Biannual	Quarterly	Quarterly

INTERNATIONAL MONETARY FUND
Public Information Notice

EXTERNAL
RELATIONS
DEPARTMENT

Public Information Notice (PIN) No. 01/85
FOR IMMEDIATE RELEASE
August 13, 2001

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

IMF Concludes 2001 Article IV Consultation with Ireland

On August 1, 2001, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Ireland.[1]

Background

The past six years have witnessed an acceleration of output growth in Ireland. Boosted by participation in EMU, sound macroeconomic and regulatory policies, and strong labor force and employment growth, real GDP expanded at an average annual rate of 9.7 percent in 1995-2000. GNP growth was commensurately rapid, with per capita income rising above the euro area average in 2000. Substantial surpluses on the general government balance and strong output growth helped to reduce dramatically the public debt ratio to an estimated 39.3 percent of GDP at end-2000 from 90.5 percent of GDP at end-1994, and to build a pension reserve fund of over 6 percent of GDP. Although signs of potential overheating appeared during 1999-2000, recent developments point to a moderation in growth to a more sustainable, albeit still high, rate.

In 2000, GDP growth surged to an estimated 11.5 percent. Domestic demand was driven mostly by private consumption and, although less so than in previous years, investment. Due in part to the buoyancy of domestic demand, the current account of the balance of payments shifted from surplus to a small deficit. Inflation also picked up and peaked at 6 percent on a harmonized basis in November reflecting the sustained weakness of the euro and temporary factors, including higher energy prices and increases in indirect taxes. House prices grew strongly before slowing somewhat toward the end of the year. The labor market continued to tighten, with the rate of unemployment falling further and the employment rate remaining well

[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. This PIN summarizes the views of the Executive Board as expressed during the August 1, 2001 Executive Board discussion based on the staff report.

above the euro area average. Reflecting this tightening, wage growth picked up somewhat, but unit labor costs remained subdued, given strong productivity growth.

The economic expansion has continued to benefit the public finances. Despite tax cuts and spending initiatives in 2000, higher-than-expected output growth and unusually high automobile sales boosted revenues substantially, yielding a record budget surplus of 4.6 percent of GDP. Fiscal policy shifted to an expansionary stance in 2001, reflecting a continuation of the structural tax reforms in progress for several years and measures taken in the context of the ongoing national wage agreement. Despite the projected fall in the actual and cyclically-adjusted budget balances, the general government finances remain in significant surplus.

The new national wage agreement, the Programme for Prosperity and Fairness (PPF), came into effect in March 2000 and envisaged nominal increases in basic pay in both the public and private sectors of 15 percent over 33 months, together with tax cuts designed to yield a 25 percent increase in disposable income during the agreement. Against the backdrop of rising inflation through most of 2000, the social partners agreed in December to an additional 2 percent pay increase in April 2001, and a once-off payment of 1 percent of each worker's annual wage in April 2002. Overall, wages are projected to grow by about 10 percent this year.

Developments thus far in 2001 point to a moderation of economic growth. With consumer and producer confidence dampened by the global economic slowdown—notably in the information technology sector—and restrictions on mobility associated with the threat of foot and mouth disease, the expansion slowed during the first half of the year. Partly reflecting these conditions, inflation decelerated to 4.1 percent (year-on-year) on a harmonized basis in May while the 12-month increase in house prices slowed to 18.4 percent in April from 21.3 percent in December 2000. Credit growth to the private sector also decelerated sharply to 18.7 percent (year-on-year) in May 2001 from a peak of 35 percent in March 2000. Labor market conditions, however, remained tight with unemployment falling to a historic low of 3.7 percent in the three months ending February.

The outlook is for GDP growth to decelerate to 7 percent in 2001 as the growth of net exports and business investment slows down reflecting global demand conditions. However, easy monetary conditions, strong growth in disposable income, and low unemployment should support private consumption and residential investment growth and cushion the slow-down. With labor force growth expected to decelerate significantly from the high rates observed in recent years and unemployment at low levels, output growth should continue to slow in 2002 and beyond as the maturing expansion converges to a more sustainable rate.

Executive Board Assessment

Executive Directors commended the authorities for Ireland's outstanding economic performance over the past decade and a half, during which income and employment grew rapidly and unemployment declined to very low levels. A substantial strengthening of public finances, a welcoming policy environment for foreign direct investment, and sustained improvement in competitiveness have contributed to these remarkable achievements.

With resource utilization at high levels, Directors welcomed the moderation in demand and output growth in 2001. They noted that the inflation differential vis-à-vis the euro area average has declined and that house price inflation has abated somewhat. Directors viewed the recent acceleration in wage increases as largely reflecting a catch-up with earlier productivity gains and, therefore, unlikely to harm competitiveness in the near term. However, they warned that if wage increases were to continue to exceed productivity growth, competitiveness could decline and growth could slow over the medium term—though Directors observed that, in the monetary union, some relative wage adjustment was to be expected since it was a mechanism to help bring output growth back to a sustainable path.

Directors observed that the economic outlook remains broadly favorable, but the authorities face a number of challenges in ensuring a smooth transition to a lower, more sustainable rate of growth. Given Ireland's openness and the importance of foreign direct investment in high technology, the deterioration in the global outlook—especially for the technology sector—poses considerable downside risks. Wages and prices will have to respond flexibly to any new adverse external shocks, and the authorities should remain alert to potential stresses in the financial system, although any possible stresses appear manageable at this stage.

Directors agreed that the fiscal stance in 2001 should have been neutral rather than expansionary. Hence, public expenditures should be held tightly to budgeted levels and any underspending saved to mitigate the fiscal easing. Most Directors considered that, provided serious overheating or recession remain unlikely, the authorities should aim at a neutral stance in 2002, and allow the full play of automatic stabilizers. They stressed the difficulty of managing a counter-cyclical fiscal policy in a small open economy. Directors recommended that any stimulative effects from improving the structure of taxes or expenditure be curtailed through offsetting measures elsewhere in the budget.

Directors welcomed the authorities' efforts to improve the tax structure. They noted that cuts in marginal tax rates and the broadening of the rate bands have contributed to reducing labor supply distortions. They suggested that there may be scope for further rationalizing of certain taxes. In particular, the social security tax regime could be reformed so as to take into account its interaction with income taxes, and the base of the VAT could be broadened and its rates standardized.

With regard to expenditures, Directors underscored the need to keep public sector wages under control. They welcome the benchmarking of public pay to private sector pay, but cautioned that offsetting budget measures may be needed if this leads to large increases in the public sector wage bill. They agreed that increased capital expenditures on physical infrastructure are clearly needed, but in view of the short-term capacity constraints, rigorous appraisal and prioritization were essential.

Directors recommended the introduction of a medium-term fiscal framework, building on elements already in place, to help clarify medium-term policy objectives and increase the transparency and predictability of fiscal policy. They stressed that any increases in public resources to specific sectors, such as health and education, should flow from a comprehensive analysis of alternative means of addressing public needs, including through greater private sector provision of such services. In addition, Directors suggested that medium-term budget plans should be accompanied by a strengthening of administrative mechanisms to hold spending departments publicly accountable for the delivery of agreed services within budgeted amounts. To identify areas where transparency can be further improved, Directors suggested that the authorities undertake a Report on the Observance of Standards and Codes on fiscal transparency at a suitable time.

Directors urged the authorities to be vigilant regarding systemic stresses in the financial sector due to slower growth and the softening of the housing market. They welcomed the efforts to implement the recommendations of last year's Financial Sector Assessment Program report and supported further strengthening of the supervisory framework by focusing on forward-looking assessments of systemic stability. Directors noted that draft legislation establishing the single regulatory authority should be approved quickly and the specialized personnel needed to strengthen insurance supervision increased as soon as the single regulator becomes operational. In view of the changing macroeconomic environment and the introduction of the single regulator, many Directors suggested that an update of the Financial System Stability Assessment (FSSA) may be useful next year, but others consider that this should not be a priority given resource constraints in the context of the overall FSAP program.

Directors observed that a number of structural reforms are desirable to help secure continued vigorous growth over the medium term. They agreed that the national wage agreements had facilitated wage moderation in the past, but considered that, in a tight labor market, such agreements may become less effective and may even act to set a floor, rather than a ceiling, on wage increases. Many Directors felt that such agreements could be a source of inflexibility in the event of an adverse shock. Directors also questioned the appropriateness of trading tax cuts for wage moderation in a tight labor market and in the face of increasing demands for public spending. While seeing the value of social dialogue on such issues as working conditions and job flexibility, most Directors suggested that the national partnership approach be reformed to allow private sector wages to be fully market determined, and public sector pay to be aligned with wages in comparable private sector jobs. They stressed the need to develop, over time, a broadly accepted and comparator-based system for determining public sector pay that would allow for greater pay differentiation.

Directors urged the authorities to strengthen competition through privatization and deregulation. They noted that greater competition, especially in sectors traditionally characterized by public monopolies such as utilities and mass transport, would also increase wage discipline. They noted that scope exists for further deregulation and stronger enforcement of existing regulations in the retail food and beverage sectors.

Directors noted the recent improvements in data reporting but called for further progress in improving the coverage and timeliness of data necessary for monitoring short-term developments—notably wages, productivity, and balance sheets, and some aspects of budget presentation.

Directors welcomed the increasing Official Development Assistance and encouraged the authorities to make further progress toward achieving by 2007 the U.N. target of 0.7 of GNP.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board. The Staff Report for the 2001 Article IV Consultation with Ireland is also available.

Ireland: Selected Economic Indicators

	1997	1998	1999	2000 1/	2001 2/
Real Economy (change in percent)					
Real GDP	10.7	8.6	9.8	11.5	7.0
Real GNP	9.3	7.8	7.8	9.8	6.3
Domestic demand	9.8	9.4	6.3	9.9	6.2
HICP	2.1	1.2	2.2	5.2	4.2
Unemployment rate (in percent)	9.8	7.4	5.6	4.3	3.7
Gross national saving 3/	23.8	24.8	23.9	23.6	23.1
Gross national investment 3/	21.5	23.4	23.3	24.5	24.9
Public Finances (percent of GDP)					
General government balance 4/	0.8	2.1	3.9	4.6	3.5
Structural balance 4/	0.0	1.4	3.1	3.1	2.2
General government debt	65	55	50	39	34
Money and Credit (end-year, percent change)					
M3E 5/	19.1	18.1	...	14.7	...
Private sector credit	29.6	22.6	33.5	20.6	...
Interest rates (year average)					
Three-month balance 6/	6.1	5.4	2.9	4.4	4.7
10-year government bond yield 6/	6.3	4.7	4.8	5.5	5.1
Balance of Payments (percent of GDP)					
Trade balance	21.0	23.1	25.9	27.3	26.8
Current account	3.1	0.9	0.6	-0.9	-1.8
Reserves (gold valued at SDR 35 per ounce end of period, in billions of SDRs)	4.8	6.7	3.9	4.1	...
Exchange Rate					
Exchange rate regime		Member of euro area			
Present rate (June 28, 2001)		US$ per euro 0.851			
Nominal effective rate (1996=100)	100.4	95.3	92.2	86.6	...
Real effective rate (1996=100, CPI based)	99.7	95.3	92.4	89.5	...

Sources: Central Statistics Office; Department of Finance, and IMF staff.
1/ Figures for 2000 based on the staff estimate of GDP as of June 29, 2001.
2/ Staff projections, except where noted.
3/ In percent of GDP.
4/ In 1999 the overall balance of 3.9 percent does not take account of discharging future pensions liabilities at a cost of 1.8 percent of GDP.
5/ ME3 was discontinued in December 1998 and the methodology for calculation of Ireland's contribution to the Euro area money supply was amended in January 1999.
6/ For 2001, average of the first five months