November 2004
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Ireland: 2004 Article IV Consultation—Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Ireland

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 2004 Article IV consultation with Ireland, the following documents have been released and are included in this package:

- the staff report for the 2004 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on July 20, 2004, 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 September 22, 2004. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its October 29, 2004 discussion of the staff report that concluded the Article IV consultation.

- a statement by the Executive Director for Ireland.

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

Selected Issues Paper

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

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

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IRELAND

Staff Report for the 2004 Article IV Consultation

Prepared by the Staff Representatives of the 2004 Consultation with Ireland

Approved by Ajai Chopra and Martin Fetherston

September 22, 2004

- The Article IV consultation discussions were held in Dublin during July 8–20, 2004. The mission comprised Mr. Chadha (head), Mr. Hunt, Ms. Koeva and Ms. Moreno-Badia (all EUR). Ms. Honjo (EUR) assisted the mission at headquarters. The mission met with the Minister for Finance, the Governor of the Central Bank, other senior officials, the employers' federation, trade unions, and members of the financial and academic communities. Mr. Bennett (Executive Director) attended the concluding meeting.

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

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

- The authorities intend to publish the staff report.

- A coalition government headed by Prime Minister Ahern, which has been in power since June 1997, was re-elected in May 2002.

- At the conclusion of the last consultation in August 2003, Directors commended the authorities for Ireland's outstanding economic performance. They emphasized, however, the need for wage growth to moderate in order to preserve competitiveness and cautioned there was a significant risk that house prices could be overvalued. Following several years of procyclical fiscal expansion, Directors welcomed the consolidation measures envisaged in the 2003 Budget.

Contents Page

Executive Summary

Background and Outlook: Over the last half of the 1990s, incomes in Ireland grew quickly and converged to the EU average as output and employment expanded. A sound macroeconomic policy framework encouraged large inflows of FDI that served as a catalyst to growth. In 2001, growth in Ireland slowed along with the slowing in the world economy. The downturn, however, was relatively mild, particularly in employment, and the economy began to recover in 2003. Inflation, which had been running well above that in the euro area for several years, converged to the average euro area rate in early 2004, although the rate of house price inflation continues to significantly exceed sustainable rates. Currently, indicators point to a continued rebound in growth to rates above those in many other industrial countries, but significantly lower than those experienced in Ireland during the late 1990s. While fiscal policy appears to have adjusted to slower growth, there are signs that expectations in other markets may still not have fully adjusted.

Policy discussions focused on the following key issues:

- What are sustainable medium-term growth rates?
- To what extent have expectations in product, labor, housing markets and fiscal policy adjusted to slower growth?
- Avoiding a procyclical fiscal policy.

There was broad agreement on the diagnostics:

- Recovery is well underway and growth in 2004 and 2005 will be between 4 percent and 5 percent, the range that appears to be sustainable over the medium term.
- Inflation will remain close to the ECB's target as resource constraints have abated and the catch-up of the Irish price level to key trading partners appears complete.
- House-price inflation continues to run well above sustainable rates and the longer it takes for them to moderate the greater the risk of a disorderly correction.
- Competitiveness has deteriorated. Although there is little evidence that this has yet had a significant negative impact, wage moderation going forward will be important to avoid further deterioration.

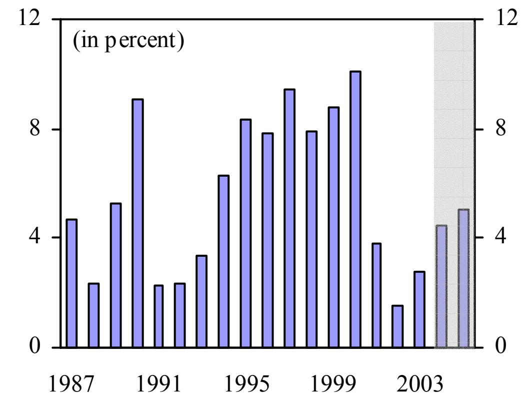
The key policy recommendations are:

- A modest tightening in the structural fiscal balance in the next budget to avoid a procyclical fiscal policy.
- The authorities should continue to communicate their views about potential overheating in the housing market to help achieve a soft landing, and look to removing the subsidies to housing over the medium-term to help moderate house-price cycles in the future.
- Shortening the duration of the wage component of the social partnership agreements to increase flexibility in nominal wages.

I. BACKGROUND AND KEY ISSUES

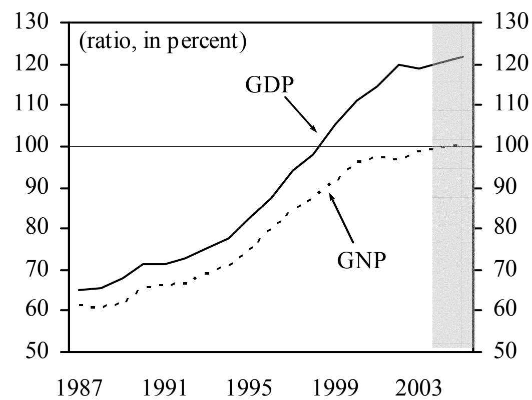
1. **Ireland experienced a remarkable economic boom in the 1990s.** Output growth averaged 10 percent a year in 1995–2000 and per capita income rapidly caught up with the EU average. A salient feature of this "Celtic Tiger" era was large increases in the proportion of the population at work (Figure 1). This reflected both favorable demographic trends that increased participation rates and a dramatic decline in unemployment, which fell from a 16 percent rate in the early 1990s to less than 4 percent by the end of 2000. Employment growth was facilitated by successive social pacts that contributed to wage moderation. Fiscal consolidation during this period, which reduced the public debt from over 100 percent of GDP in 1988 to 36 percent by 2001, provided an important impetus to growth. Rapid revenue growth combined with prudent public spending created the scope for cutting taxes, with reductions in income tax facilitating agreements on wage moderation, while low corporate tax rates encouraged foreign investment. Membership of the EU provided structural funds for infrastructure investment while EMU lowered interest rates and encouraged FDI, particularly from the US, with local operations providing access to a large market. The global ICT boom further boosted FDI, while the depreciation of the euro following its inception aided competitiveness. The latter part of the boom was associated with sharp increases in inflation and property prices, raising concerns about a hard landing and financial system soundness.

Real GNP Growth



Sources: CSO, staff estimates.

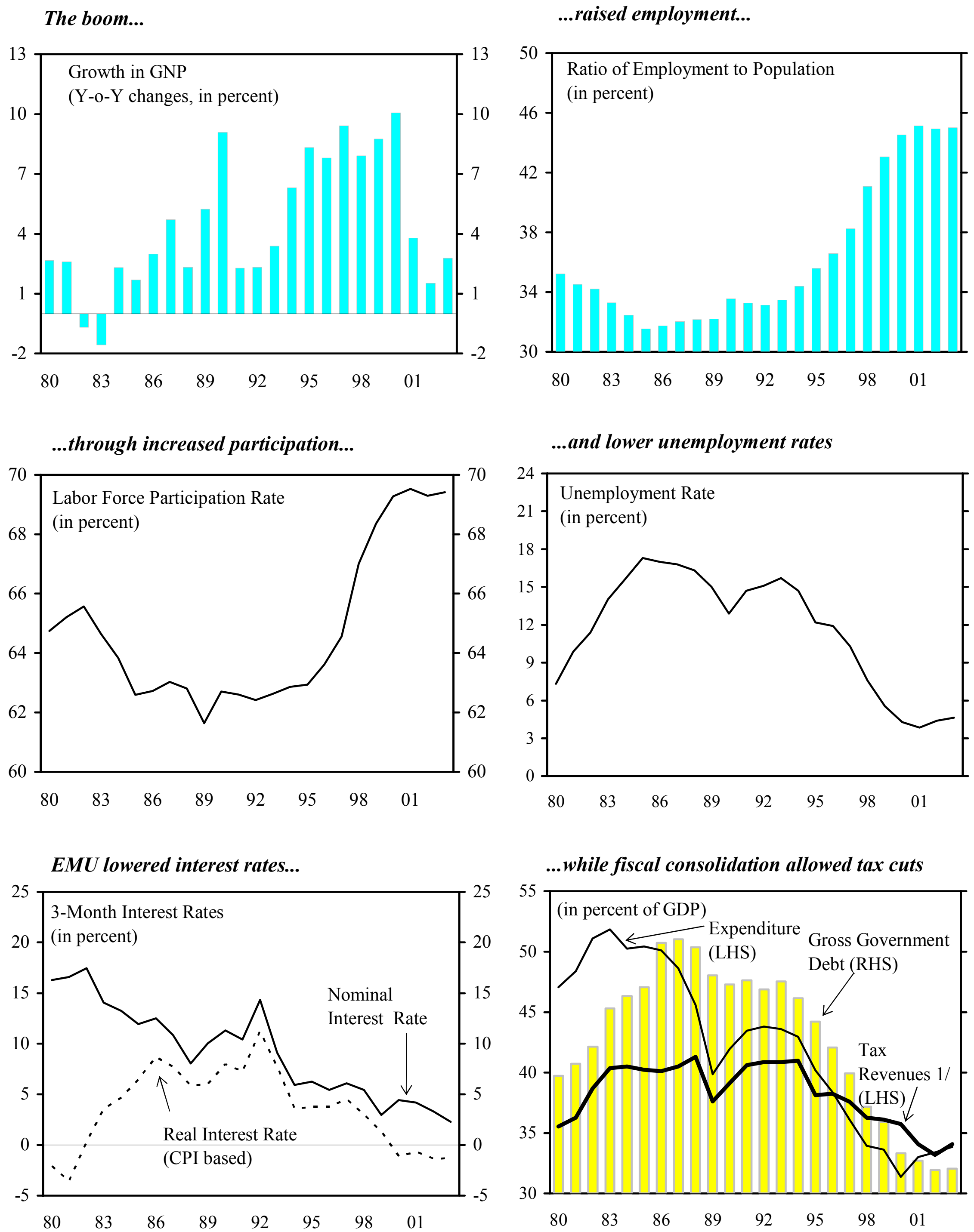
Per Capita Output in Ireland versus the EU



Source: AMECO.

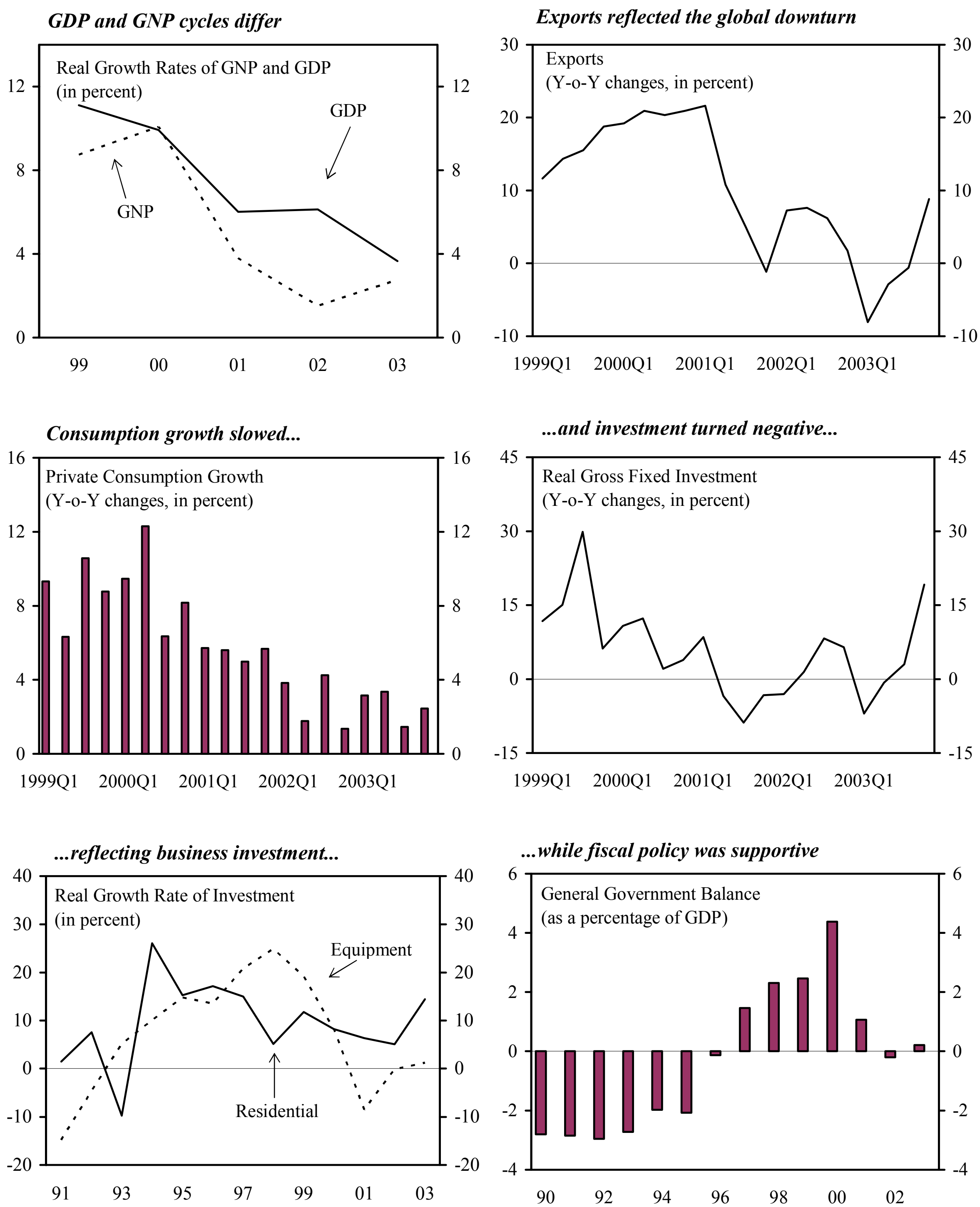
2. **In the event, following the global downturn, growth slowed sharply in mid-2001.** The substantial contribution of multinationals to Irish output and associated profit flows creates significant differences between measures of output, and the recent cycles in GDP and GNP have not been synchronized (Figure 2). When measured by GNP, which excludes payments to foreign factors of production and better reflects domestic economic activity, growth decelerated from around 10 percent in 2000 to 1½ percent in 2002. Household consumption growth slowed, while business investment collapsed in the aftermath of the

Figure 1. Ireland: The Boom.



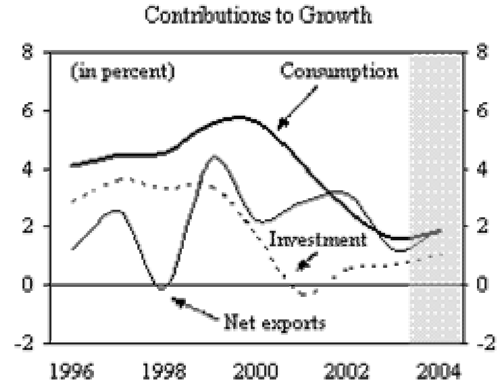
Sources: AMECO, Central Statistics Office, MBTS, OECD, and staff estimates.
1/ Tax revenues including Social Security Contributions and Capital Taxes.

Figure 2. Ireland: The Slowdown.



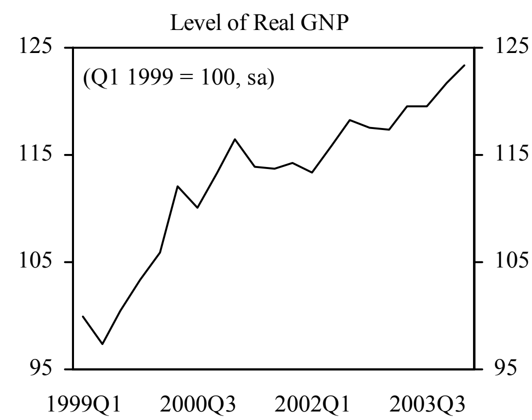
Source: Central Statistics Office.

bursting of the global ICT bubble but residential investment remained robust. The labor market was relatively resilient to the slowdown (Figure 3). Cushioned by slower increases in labor force participation rates, increases in public sector employment and in part-time work, unemployment gradually inched up from a low of 3.7 percent in January 2001 to 4.8 percent by July 2003. Domestic demand was supported by the ECB's easing of monetary policy and an expansionary fiscal policy. Even as export growth decelerated sharply in 2001–02, net exports remained a significant positive contributor to growth as import growth, especially of capital goods, fell more.



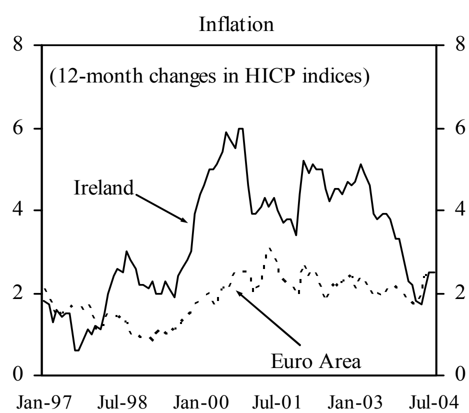
Sources: CSO, staff estimates.

3. **In sync with the global upturn, growth picked up in 2003.** In line with the global recovery in manufacturing, industrial production rose steadily over the year, while rising new export orders saw the PMI rebound strongly in the second half (Figure 4). Private consumption was supported by a recovery in consumer confidence from its trough in the summer and a gradual inching down of unemployment. The drop off in nonresidential investment slowed through the year while residential investment accelerated sharply. Overall GNP growth was 2.8 percent in 2003.



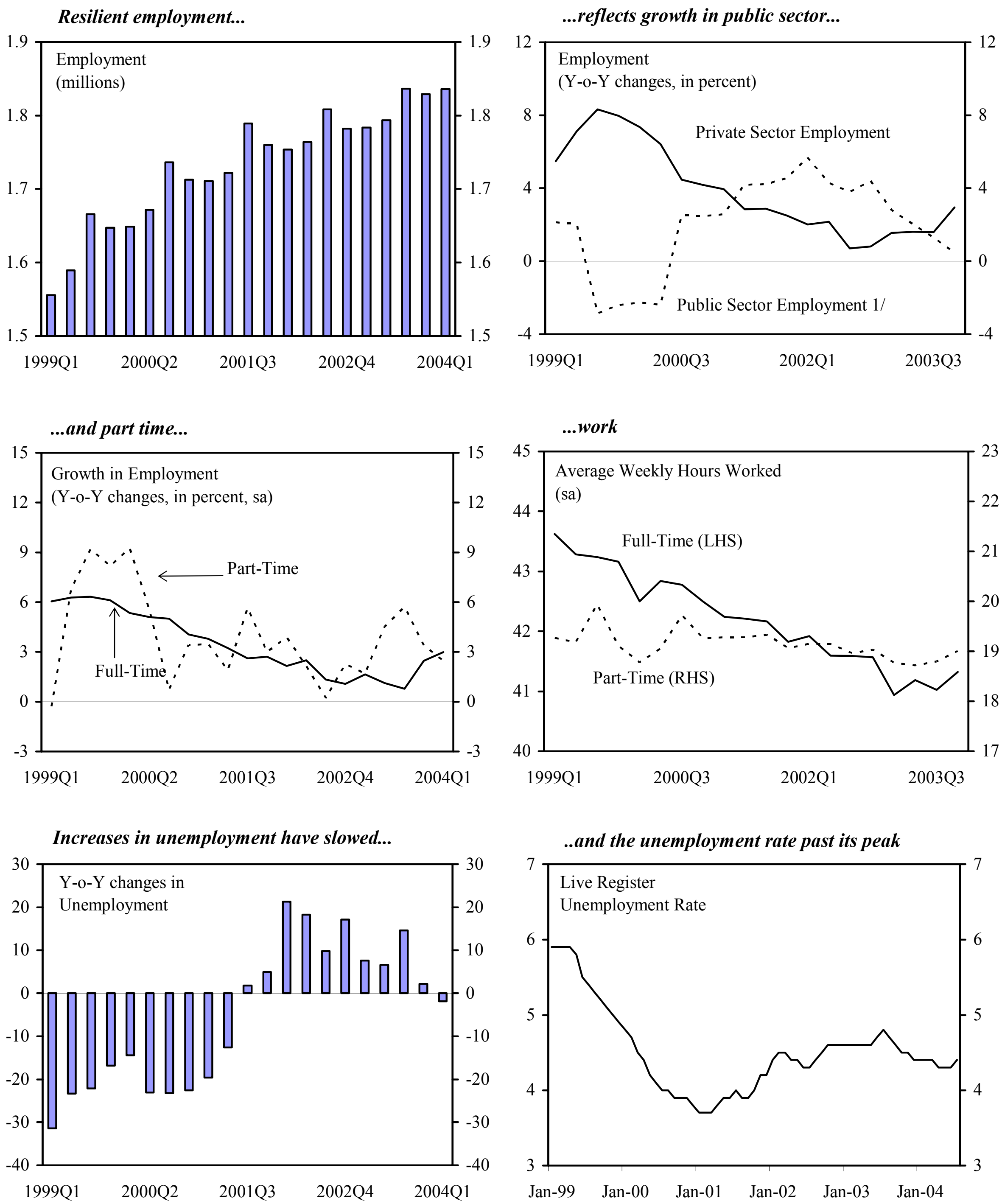
Source: CSO.

4. **With a lag, consumer price and wage inflation eased but house price inflation rekindled.** Having substantially exceeded the euro area average since 1998, consumer price inflation decelerated sharply during the course of 2003 (Figure 5). As the lagged effects of easing resource pressures and especially the appreciation of the euro (Figure 6) fed through, HICP inflation fell from around 5 percent in February 2003 to 1¾ percent in April this year, below the euro area average, before picking up to 2½ percent most recently reflecting higher oil prices. Wage growth also eased, falling from an average of around 9 percent in 2001 to some 5 percent in 2003. Following a significant slowing in late 2001, the rate of house price increases rose to around 15 percent in 2003 and is running just below this presently (Figure 7).



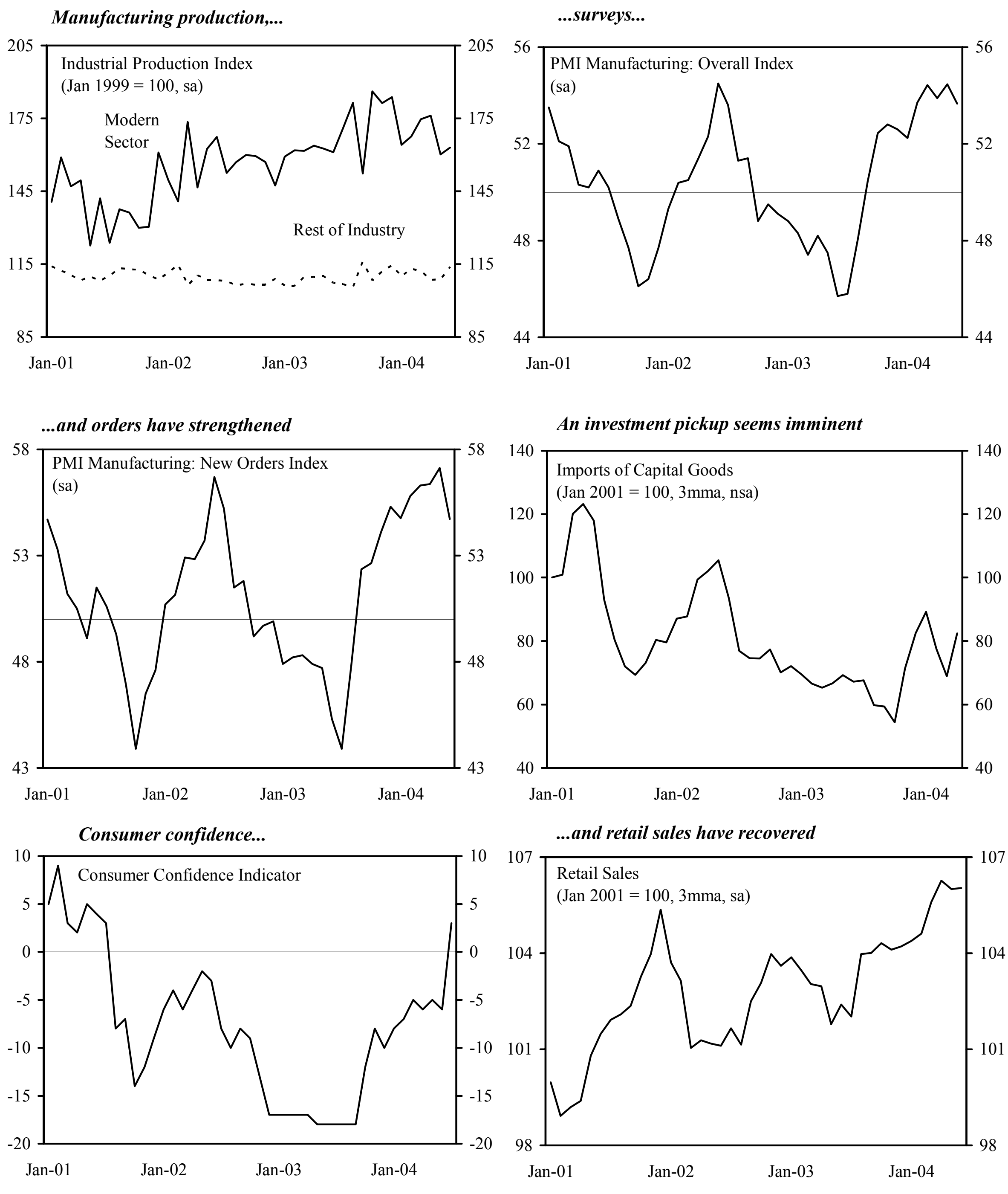
Source: EuroStat.

Figure 3. Ireland: The Labor Market has been resilient.



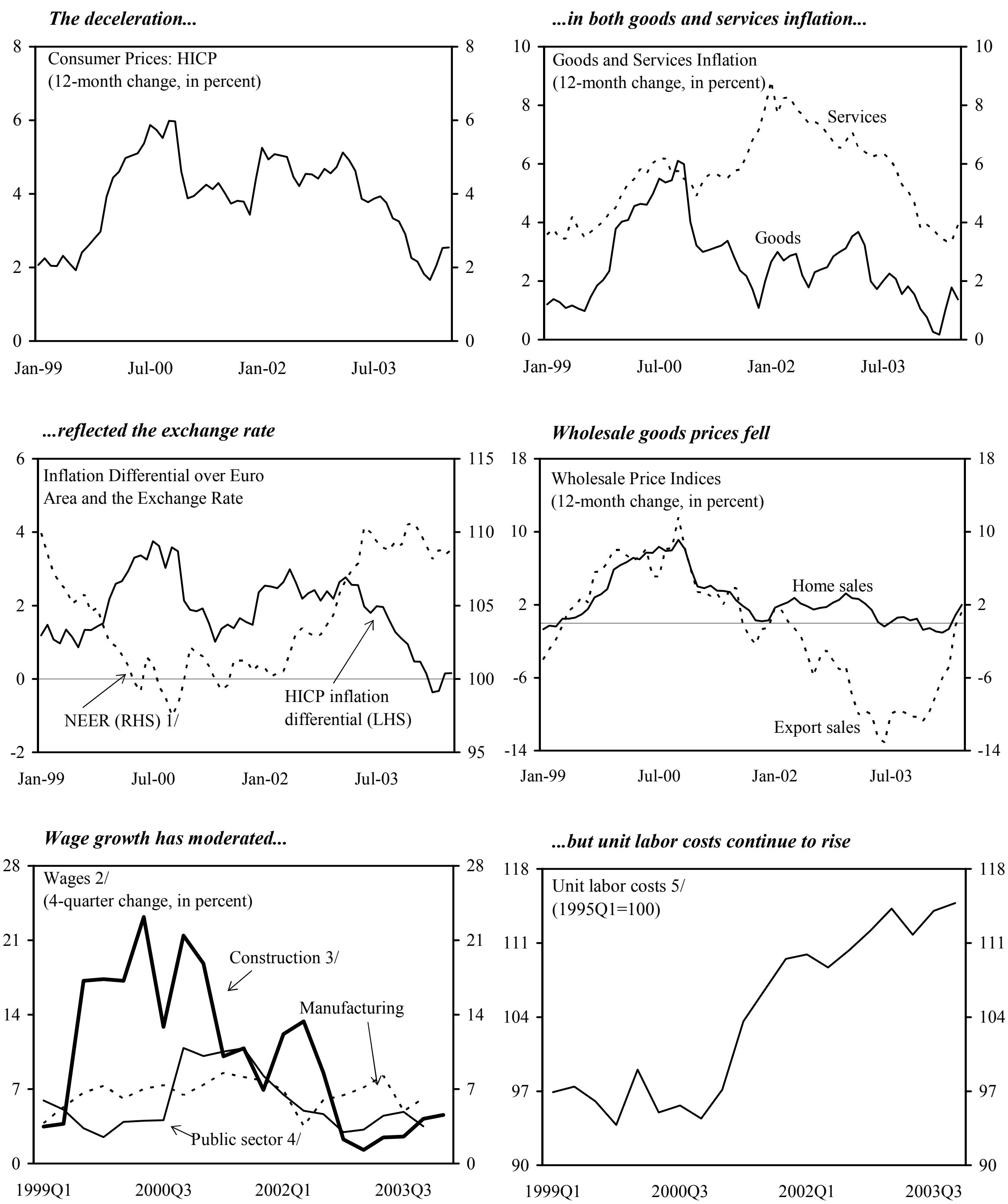
Source: Central Statistics Office.
1/ Excluding health.

Figure 4. Ireland: Signs of Recovery.



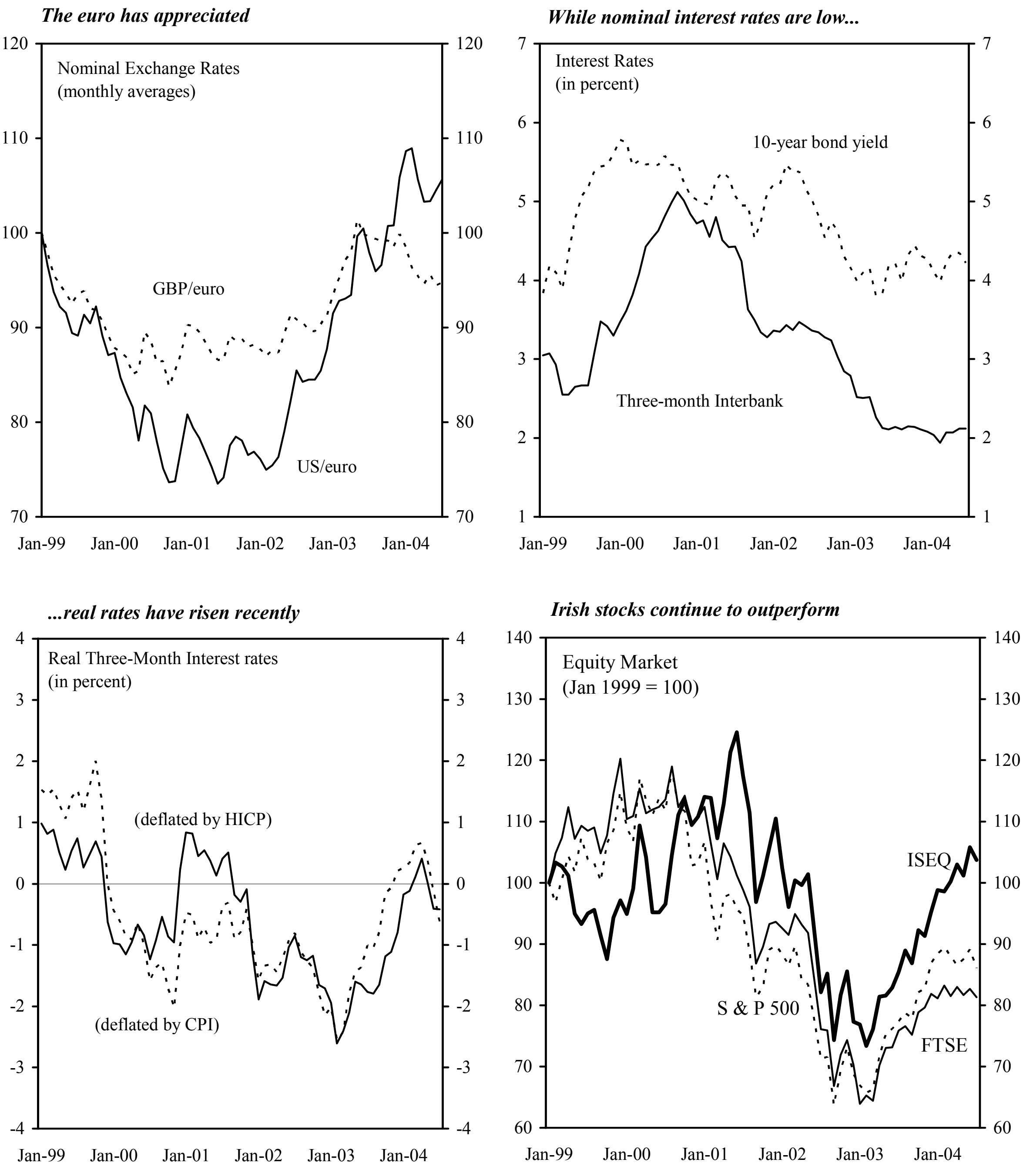
Sources: Central Statistics Office, EuroStat, and NCB Stockbrokers Limited.

Figure 5. Ireland: Inflation has fallen



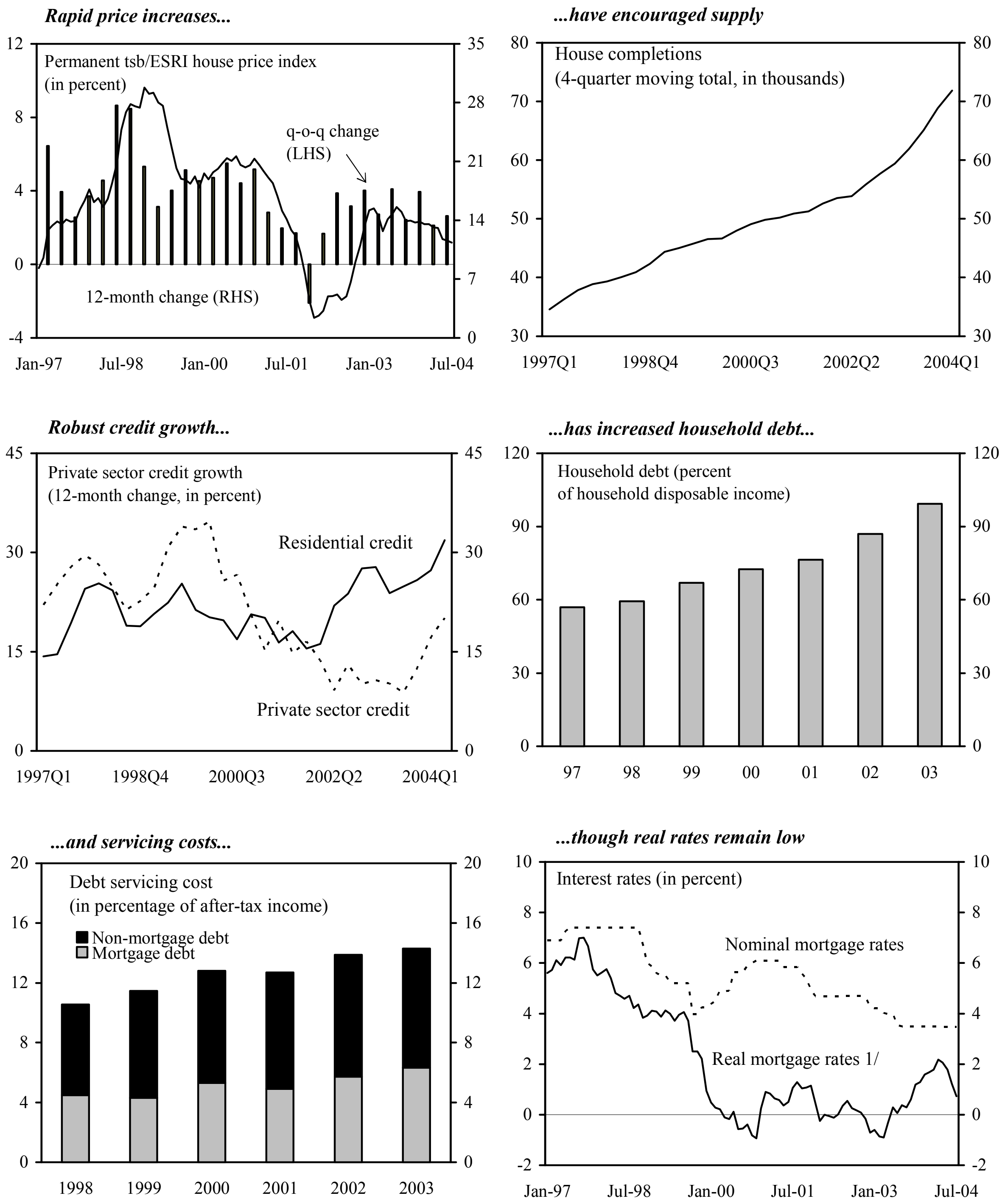
Sources: Central Statistics Office, Eurostat, IFS, and staff estimates.
1/ Nominal effective exchange rate based on ULC.
2/ Average weekly earnings, seasonally adjusted.
3/ Building and construction (unskilled)
4/ Public sector excluding health.
5/ Unit labor cost in manufacturing weighted by employment shares in subsectors.

Figure 6. Ireland: Exchange and Interest Rates



Source: Bloomberg, DataStream, MBTS.

Figure 7. Ireland: Housing is booming



Sources: Central Bank and Financial Services Authority of Ireland, Central Statistics Office, Davy Stockbrokers, the Department of the Environment, Heritage and Local Government, OECD, and Permanent tsb.
1/ Nominal mortgage rates deflated by the CPI.

5. **Ireland has generally responded appropriately to policy challenges identified in previous Article IV consultations.** Fiscal policies were expansionary in 2000–02, contrary to Fund advice. However, beginning with the 2003 Budget, the authorities took steps consistent with Fund advice towards consolidating the public finances and the 2004 Budget has held the line. Furthermore, no new temporary fiscal initiatives have been introduced that attempt to fine tune the housing market. In contrast to its predecessors, the present social partnership agreement signed in spring 2003 offered no fiscal concessions, a step in line with the Fund's recommendation. The latest agreement on wage increases presents a considerable degree of wage moderation relative to the past. Financial supervision has and continues to be strengthened along the lines recommended in the 2000 FSAP. Progress in improving public expenditure efficiency, controlling public sector wages, and increasing domestic competition has been more limited.

6. **The relative resilience of activity during the global downturn and the abatement of inflationary pressures suggest a remarkably soft landing from the boom but there are significant challenges and risks in managing the transition to slower growth.** With many of the factors accounting for the boom such as the increased employment rate and productivity catch up being one-off by nature, medium-term growth prospects are decidedly lower than in the Celtic Tiger era. Indications are that competitiveness has deteriorated significantly and there are risks from further euro appreciation, while house price increases continue at a rapid pace and there are risks of an abrupt unwinding. There remain large infrastructure needs and a strong demand for higher quality public services. Against this background, this year's discussions focused on:

- What are sustainable medium-term growth rates?
- To what extent have expectations in product, labor, housing markets, and fiscal policy adjusted to slower growth? Are the risks being factored in?
- Avoiding a procyclical easing of fiscal policy and achieving value-for-money in public expenditures.

II. Report on the Discussions

A. The Outlook: Recovery to Lower Potential Rates

7. **In the near term, the shared prospect is for the recovery to strengthen and become more broad-based.** Staff's baseline forecast sees GNP growth picking up to 4½ percent in 2004, with a slightly higher increase in GDP (Table 1). External demand continues to improve though the euro's appreciation last year will be a restraining influence. With consumer confidence recovering, household spending will rise along with disposable incomes and employment. The recovery in equipment investment is expected to strengthen, while residential investment could well exceed last year's vigorous pace. At the time of the mission, the authorities agreed with the qualitative characterization of improved growth

prospects, and the Department of Finance's recent update of prospects for 2004 is largely in line with staff's forecasts.

8. **There is broad agreement on the overall prospects for 2005.** Staff forecasts GNP growth to rise to 5 percent in 2005 and the authorities acknowledged that their latest official projections of around 4 percent, made at the time of the budget in December 2003, would need to be revised. The outlook reflects the balance of countervailing forces. The widely held expectation is that residential investment should at least decelerate from its extraordinary pace. External demand is projected to also slow as excess capacity in the world economy gets utilized and growth falls to trend rates. Household spending will be supported by increasing incomes and a tightening labor market but a key issue is the extent to which consumption will be restrained by higher debt-servicing costs as interest rates begin to normalize, with the staff emphasizing the implications of the rapid run up in household debt levels. Equipment investment is expected to rebound strongly from substantially depressed levels.

9. **The shared outlook is for inflation to remain moderate.** Barring major exchange rate changes, staff sees underlying or "core" inflation remaining in the vicinity of 2 percent on a HICP basis, though headline rates will be buffeted by oil prices, while the authorities saw a somewhat higher average rate. From a cyclical viewpoint, staff estimates that the build up of slack during the slowdown was limited and is dissipated under the baseline by next year with little implication for inflation. While sharing the assessment of slack as being limited, the authorities saw faster prospective tightening in the labor market and saw greater potential for wage inflation picking up. From a secular viewpoint, there was agreement that the "catch up" of the Irish price level to other developed countries appears complete and should not be a factor.

10. **While the risks to the near-term growth outlook are broadly balanced, further out the staff sees the risks as being on the downside.** In the near term, downside risks to external demand from the euro area are offset by upside risks elsewhere, particularly the UK. Looking ahead, significant further euro appreciation in response to global imbalances presents an important downside risk. Staff emphasized and the authorities acknowledged the risks to growth from the potential unwinding of the spectacular booms in house prices and construction (see Section II. C below). On inflation, the slow adjustment of expectations to lower productivity growth and inflation prospects and the potential feed-through of oil price increases to wages and services inflation tilts the risks to the upside.

11. **There is strong agreement that medium-term growth prospects are decidedly lower than they were in the second half of the 1990s.** Many of the factors that accounted for the 1990s boom are best thought of as raising the level rather than the growth rate of output. Using a growth accounting framework that embodies a tapering off in productivity catch up and labor force participation rates, staff estimates medium-term potential GNP growth to be at the mid-

Output per hour (US = 100)

	GDP per hour		Working hours per person	
	1970	2000	1970	2000
USA	100.0	100.0	100.0	100.0
Ireland	39.2	97.7	116.2	90.5
Ireland (GNP)	39.9	84.2	...	...
UK	58.7	80.3	103.5	88.0
EU-15	64.8	90.7	101.0	85.6

Source: EU Commission Sapir Report (2003) p. 23.

point of the typically cited range of 4–5 percent.[1] Such rates are less than half the average experienced in 1995–2000. There was agreement that potential growth in Ireland is endogenous to a greater degree than in other advanced countries in that capital accumulation is affected importantly by FDI and, therefore, competitiveness, while increases in labor supply depend on migration flows and increasing participation rates, both of which have proved responsive to market conditions. In the budget and official projections, the authorities work with estimates of potential growth obtained from the methodology agreed between EU countries and the European Commission. This methodology currently yields estimates of current potential growth that are significantly above the 4–5 percent range reflecting the weight given by the filtering techniques employed to the boom period. The authorities did not disagree with staff views that the methodology likely overstated potential growth over the medium term and they noted that conditions in the labor market suggested that there was only limited slack in the economy presently.

Potential Growth Rates in Stability Programmes

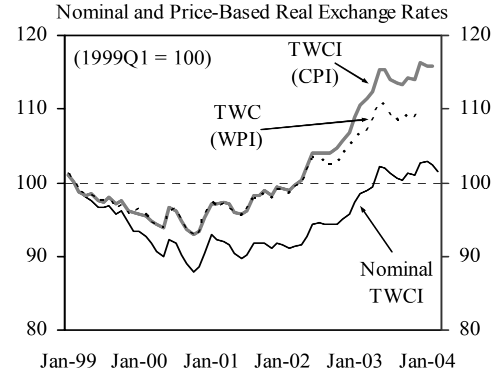
	2000	2001	2002	2003	2004	2005	2006
SP 2001	7.7	7.4	7.1	6.8	6.5	-	-
SP 2002	-	7.5	7	6.5	6.3	5.8	-
SP 2003	-	-	7.0	6.3	5.9	5.6	5.2

Source: Department of Finance.

B. Competitiveness and Incomes Policy Requirements

12. **The rapid reduction and convergence of inflation is encouraging, but concerns about the erosion of competitiveness have grown.** On a number of measures, competitiveness has eroded significantly. With the strengthening of the euro during 2002–03, the nominal effective exchange rate has now essentially reverted to its level during the relatively stable 1995–98 period. However, with inflation rates persistently in excess of those in partner countries for six years, Ireland's price level has risen well above those in its main trading partners and the consumer-price-based real exchange rate now stands some 15 percent above its level during 1995–98.

Nominal and Price-Based Real Exchange Rates



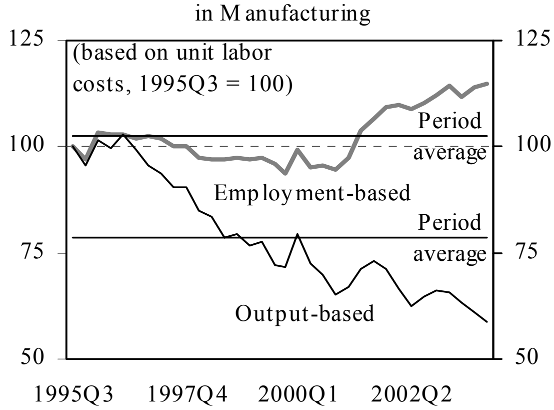
Source: Central Bank of Ireland.

13. **Staff estimates a deterioration in the competitiveness of the manufacturing sector of a similar order.** The traditional output-weighted real exchange rate for manufacturing suggests only a pause in the rate of trend real depreciation, but this measure is not representative of broad competitiveness developments in the sector. As is now widely recognized, aggregate manufacturing measures for Ireland are distorted by the presence of a handful of sectors dominated by multinationals with limited employment whose gains in productivity often represent returns from intangible foreign inputs into production such as

[1] See *Selected Issues* paper "Potential Growth After the Boom".

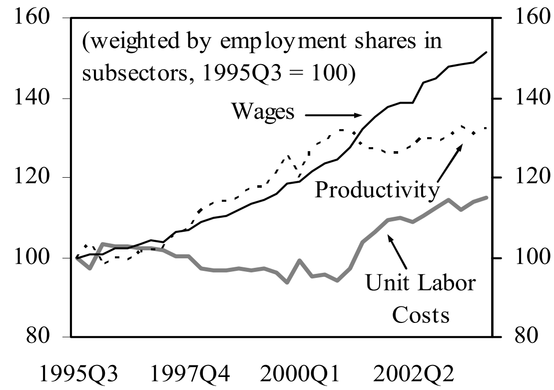
returns on past R&D, patents and advertising campaigns abroad.[2] In contrast, the more relevant employment-weighted real exchange rate index for manufacturing has appreciated by some 15 percent over 1995–98 levels. This deterioration has reflected entirely increases in wages in excess of those in productivity since the slowdown began in 2001.

Labor Cost-Based Real Exchange Rates in Manufacturing



Sources: CSO, staff estimates.

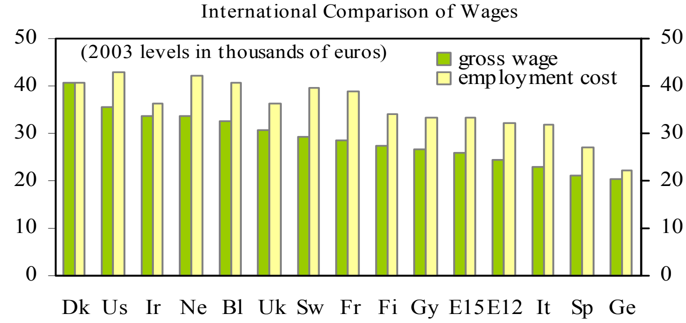
Decomposition of Unit Labor Costs in Manufacturing



Sources: CSO, staff estimates.

14. **Encouraging recent export and FDI performance has allayed concerns in some quarters about the losses in competitiveness, but staff and the authorities agreed that risks remain.** First, the authorities indicated that the muted effects of declines in competitiveness in part reflect a willingness on the part of firms to temporarily absorb declines in profit margins and a lagged adverse response of output and employment could be forthcoming. Second, erosions in competitiveness increase the speed with which the composition of FDI flows needs to move to higher value added activities. Here a proactive industrial policy has been effective in facilitating such a shift but the necessary upgrading of skills will have to keep pace. The loss of indigenous industries also increases the reliance on the modern and inherently more mobile high-technology sector. Third, high rates of services inflation may deter labor supply as suggested by the recent slowdown in female labor force participation rates as childcare costs rose. Finally, there is anecdotal evidence of high relative house prices deterring inward migration.

International Comparison of Wages



Source: European Commission.

15. **The increase negotiated in the recent wage agreement is moderate.** The wage increase recently negotiated in the second phase of the Sustaining Progress agreement, which forms a benchmark for wage expectations and negotiations in the economy of 5½ percent over 18 months (averaging 3⅔ percent a year) is in

[2] See *Selected Issues* paper "The Competitiveness of Irish Manufacturing: An Update".

line with lower prospective core inflation and productivity developments. There was agreement that with wages in Ireland now amongst the highest in the world, there is a strong case for these agreements not to be exceeded as they often have been in the past.

16. **The three-year national wage agreements have served Ireland well but the tradeoff between greater wage flexibility and the costs of renegotiation is likely to shift.**[3] The recent trend of not relying on granting fiscal concessions within the social partnership to facilitate agreement has been welcome and there is agreement that both the scope for offering further concessions and their potential benefits were now limited. The present three-year agreement is the first to have broken up the wage negotiations into two sub-periods. This change was agreed by the social partners at the time on the grounds of the prevailing economic uncertainty following the Iraq conflict. Staff argued for its maintenance going forward on the grounds of the benefits of greater flexibility in wages in the face of a limited potential for persistent upside surprises in growth than had been the case in the late 1990s. While recognizing the importance of increasing wage flexibility within the social partnership framework, the authorities noted the significant logistical and practical difficulties associated with more frequent negotiations, and the heavy burden this would place on the social partnership process.

17. **Competitive and flexible markets are critical to sustaining high levels of macroeconomic performance.** Ireland compares well with other countries on indicators of labor market regulation, regulatory burden, levels of bureaucracy, and the administrative burden for start-up firms, but ranks poorly on competition legislation and the intensity of local competition. Improving competition in the non-traded sector, both public and private, is essential for containing the growth of input costs into the traded sector and maintaining external competitiveness. The authorities indicated a number of steps that continue to be taken in this direction. Specifically, two of the reviews of restrictive practices in the professions have been completed and the governing bodies have agreed to the removal of the major restrictions identified. However, the staff noted

Indicators of Regulation and Competition

	Regulation Indicators				Competition Indicators	
	Labour Market	Burden of regulation	Levels of bureaucracy	Administrative burden for start-up firms	Intensity of local competition	Competition legislation
Ireland	**4**	**2**	**6**	**6**	**13**	**10**
Denmark	2	8	2	8	13	2
Finland	6	1	1	1	9	1
France	15	13	13	16	15	9
Germany	16	14	15	11	2	3
Hungary	3	5	9	5	11	15
Italy	11	16	14	15	12	12
Japan	8	14	12	12	4	11
Korea	14	9	11	8	5	13
Netherlands	9	11	7	7	5	5
New Zealand	7	7	5	3	5	4
Poland	13	12	16	14	15	16
Spain	10	5	8	12	9	14
Sweden	12	10	3	8	5	7
UK	5	3	10	3	2	8
US	1	4	4	1	1	6

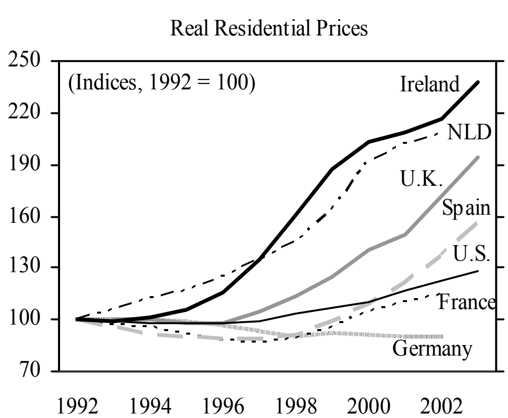
Source: Annual Competitiveness Report 2003, National Competitiveness Council, Dublin, Ireland.
Note: The lower the rank the lower the burden of regulation and the more competitive the business environment.

[3] See *Selected Issues* paper "The Role of Social Partnership Agreements in Ireland".

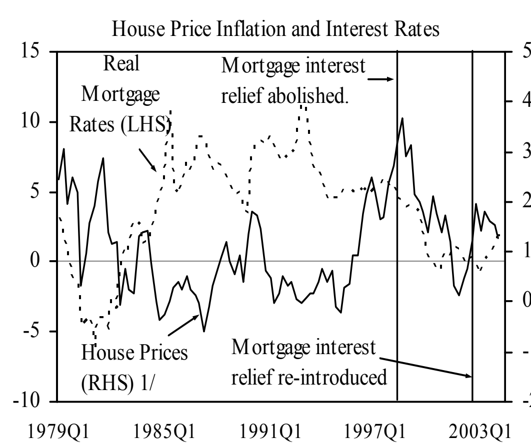
that progress on the reviews of the remaining six professions has been slow and that steps toward improving efficiency in public transportation have been met with resistance by public sector unions. Overall, results appear to have been limited and the scope for hastening progress in these areas seems considerable.

C. Continued Ebullience in the Housing Market

18. **Rapidly rising property prices in the face of slow growth have been a feature in many countries recently, but the extent, scale and duration of the boom in Ireland set it apart.** There is agreement that there are many fundamental reasons for why the boom in Ireland should have been bigger: the enormous increases in disposable incomes and employment during the Celtic Tiger era, demographic factors, the change in direction of migration flows, lower and less volatile interest rates following EMU, and financial liberalization and innovation that increased the supply of lending. In addition, the authorities emphasized the strong preference in Ireland for owning property as a factor. The dynamics of house prices have also been affected by tax changes, such as the re-introduction of interest tax deductibility for residential investment mortgages in the 2002 budget. Accompanying the house price boom have been record increases in mortgage credit, which reached a pace of 27 percent recently and household debt has risen to 100 percent of after-tax income, up from 60 percent in 1998. On the supply side, an enormous response has been forthcoming. Last year, some 69 thousand new homes were built, representing 17 new houses per thousand of the population, as compared to 6 in the US, less than 5 in Europe, and less than 3 in the UK.



Sources: BIS, staff estimates.

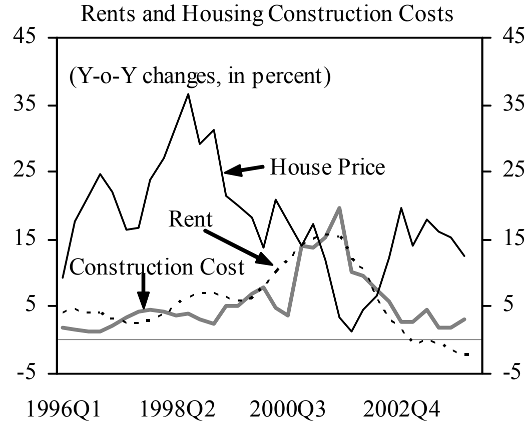


Sources: CSO, The Department of the Environment, Heritage and Local Government.
1/ Second-hand house prices, 12-month changes, in percent.

19. **The question remains whether the house price increases to date have outstripped developments in fundamentals.** During last year's consultation, the staff presented empirical evidence suggesting price increases had exceeded those that would have been suggested by developments in traditional demand-side factors (disposable incomes,

demographics and interest rates).[4] The authorities noted that a number of observers have since argued that adding supply-side factors, measured in particular by the price of building land, building costs and the availability of mortgage loans, sufficiently explain house price developments.[5] The staff, while sympathetic to the inclusion of supply-side elements, views the price of land, building costs and the expansion in mortgage lending as largely endogenous to the real estate cycle. The authorities also pointed to relatively low household headship rates (or inversely, relatively large family sizes) in Ireland compared to other EU countries and the implication for house price increases in anticipation of future demand as these rates rise over time. While accepting that it could be debated, in the staff's view there are elements of exuberance in price developments beyond those suggested by fundamentals, particularly in light of the massive increases in supply seen recently. This view is reinforced by a variety of other indicators: some 40 percent of new houses are being purchased as second or buy-to-let properties;[6] buy-to-let transactions account for 20 percent of all new mortgages; and building has accelerated despite rents and the rental yield on new construction falling sharply.

Rents and Housing Construction Costs



Sources: The Department of the Environment, Heritage and Local Government, and EuroStat.

20. **There is greater agreement that recent rates of price increase are running above sustainable rates dictated by medium-term growth prospects and the longer they fail to moderate the greater the vulnerability to a possibly disorderly correction.** The staff argued that because real estate represents an asset price whose valuation depends not only on current but also on future demand and supply conditions, future income growth is an appropriate benchmark against which to gauge the sustainability of price developments.[7] Recent rates of house price increase of 12–15 percent are out of line with medium-term income-growth prospects of 4–5 percent in real, and 6–7 percent in nominal terms. There was agreement that the predominance of mortgages at variable rates and significantly increased household debt levels made the housing market in Ireland vulnerable to sharp increases in

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[4] See "Can Fundamentals Explain the Growth of House Prices in Ireland?" in Country Report 03/242.

[5] See "Will there be a crash in Irish house prices?", Maurice Roche, ESRI, Winter 2003, and "A Model of the Irish Housing Sector" by Kieran McQuinn, Research Technical Paper, CBFSA, April 2004.

[6] See "Where have all the houses gone?", Davy Stockbrokers, November 2003.

[7] See *Selected Issues* paper "Adjustment in the Housing Market".

interest rates, though market expectations of the monetary policy tightening cycle in the euro area are for moderate and gradual increases.

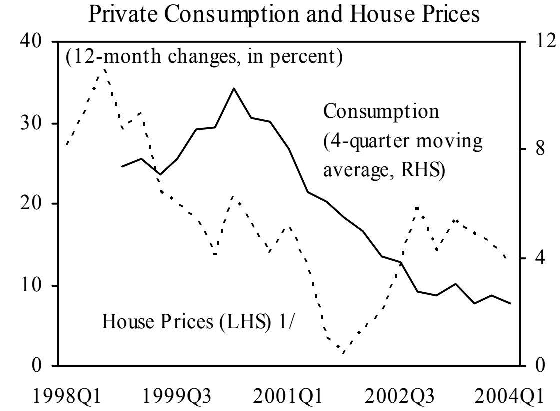
21. **In the near term, public communication can play an important role in taming expectations and help induce a soft landing in the housing market but over the medium-term structural aspects of the housing market must be addressed.** The staff strongly supports the Central Bank's public expressions of concern regarding recent rates of house price increase and credit growth. Beyond the present conjuncture, the staff argued that policy needs to confront the basic issue that the oft-cited strong preference for home ownership and asset-of-choice for saving in Ireland is an argument against subsidizing housing as such incentives exacerbate price movements when ability-to-buy rises. There is thus a strong case for removing the interest-deductibility of mortgage payments on primary dwellings and for introducing a market-value-based wealth tax on property. Although second homes are not subsidized, they are not taxed either and, given the still scarce infrastructure being provided to these homes, there is a good argument that they should be. The authorities noted the political, likely insurmountable, difficulties of removing interest-deductibility of mortgages or introducing taxation on property given the electorate's long history of strong attachment to, and preference for owning, property.

22. **High profitability and capitalization levels have bolstered the capacity of the domestic banking system to withstand shocks without creating systemic stress.** Following rapid increases in lending, the property sector now represents about half of banks' loan books (residential mortgages 34 percent; commercial property 12 percent; and construction 4 percent). The authorities noted that the results of stress tests indicated that strong capitalization levels provided a significant cushion for absorbing sharp declines in property prices with simultaneous increases in unemployment and interest rates, a view shared by the rating agencies. The authorities and private banks also noted that low effective loan-to-value ratios meant that prices would have to fall considerably before negative equity considerations came into play and there is a strong culture of servicing mortgages in Ireland, as evidenced by the low (1 to 20 basis points) rates of bad or nonperforming mortgages despite the recent growth slowdown. Nearer term, the staff welcomed strengthened surveillance by the supervisory authority to ensure that sufficient account is taken of prudential concerns in banks' lending behavior. Staff argued that greater attention needs be paid to factoring in the effects of the normalization of interest rates from their present cyclical lows and efforts made to increase borrower awareness of the prospects for interest rates and their impact on debt servicing costs.

23. **A sharp correction in the housing market could have macroeconomic consequences, although financial stability is likely not a concern.** The authorities noted that while increases in house prices have undoubtedly increased the perceived wealth of homeowners, unlike in some other countries, mortgage equity withdrawals are not prevalent in Ireland. There has not been a strong identifiable relationship between aggregate consumption and house prices either, with the former following more closely developments in disposable income. Thus there is reason to doubt that a correction in house prices would directly slow consumption appreciably. The authorities acknowledged though that such a

correction could harm consumer confidence. The authorities stressed that the more relevant channel for a potential impact was through unemployment with coincident large increases in interest rates being the scenario of greatest concern. With new house building representing some 12 percent of GNP last year as compared, for example, to 5 percent in the US and 3 percent in the UK, depending on the severity of the correction, the associated employment losses could have a macroeconomic dimension. A key question is the likely size and duration of the up-tick in unemployment. The authorities and other observers in Ireland noted they were encouraged by the flexibility in the labor market evident during the recent downturn which suggested that labor shed by the construction sector could be absorbed quickly elsewhere in the economy. The staff was more agnostic, noting that the construction boom had been ongoing prior to the slowdown and gathered momentum during the downturn spurred by lower interest rates and tax changes, while increases in public employment had also helped mitigate the effects on unemployment. It is not clear whether a significant autonomous increase in unemployment in the non-traded sector could be absorbed by the traded sector as easily since there was certainly no reason to expect a coincident upswing there and skill-matching would likely be an issue.

Private Consumption and House Prices

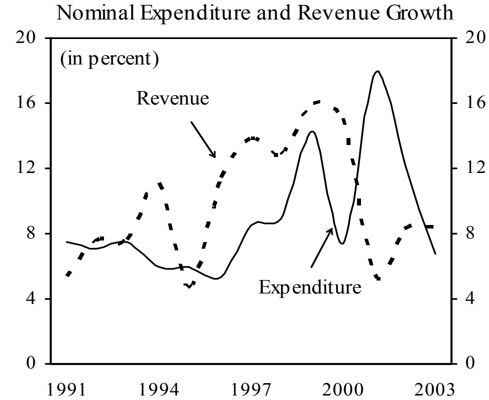


Sources: CSO, The Department of the Environment, Heritage and Local Government.
1/ Second-hand house prices.

D. Fiscal Policy: Avoiding Procyclical Pressures and Getting Value for Money

24. **Following two years of disappointing outcomes and larger-than-anticipated deficits, the 2003 Budget took measures to adjust to slower growth and halt the deterioration.** Nominal expenditure growth was lowered from clearly unsustainable rates of 18 percent and 12 percent in 2001 and 2002, respectively, to 7 percent in 2003, and indirect taxes were raised. In the event, the budget outturn surprised considerably on the upside, which the authorities attributed largely to factors unrelated to the economic cycle. Higher-than-expected receipts from changes in the capital-gains tax regime and from stamp duties reflecting the buoyancy of the property market yielded a nominal surplus of 0.2 percent of GDP, almost 1 percent of GDP better than budgeted.

Nominal Expenditure and Revenue Growth



25. **The 2004 Budget continued the pattern of holding expenditure growth down in line with lower revenue and economic growth but revenue outturns so far have again exceeded expectations.** The budget, framed before the final outturn for 2003 was available, envisaged a small improvement in the cyclically-adjusted balance of about ¼ percent of GDP and a nominal deficit of 1.1 percent of GDP. The authorities attribute the well-above-expected revenue performance so far this year to one-off successes with anti-fraud measures as well as the continued buoyancy of the property market. They believe both current and capital expenditures will continue to be broadly in line with the budget. These developments have prompted staff to revise its projections to a nominal fiscal deficit of ⅓ percent of GDP this year. Excluding one-off effects, the staff projects a structural or underlying deficit this year of about ½ percent of GDP (Table 5).

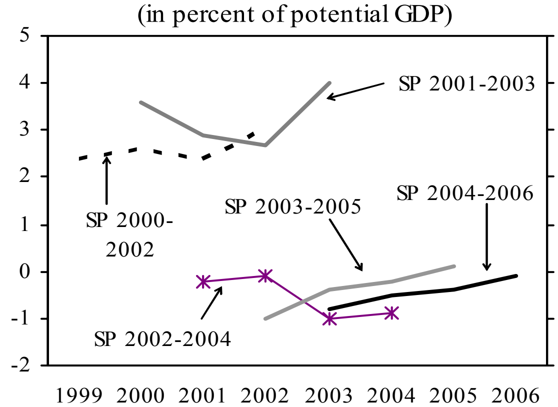
Projected and Actual Growth in Tax Receipts

Tax category	Jan-July 2004 Outturn (y-o-y)	2004 Budget (y-o-y)
Income	24.9	10.0
VAT	10.6	6.7
Corporate	-15.7	3.6
Excises	12.0	6.4
Stamp duties	17.8	-5.2

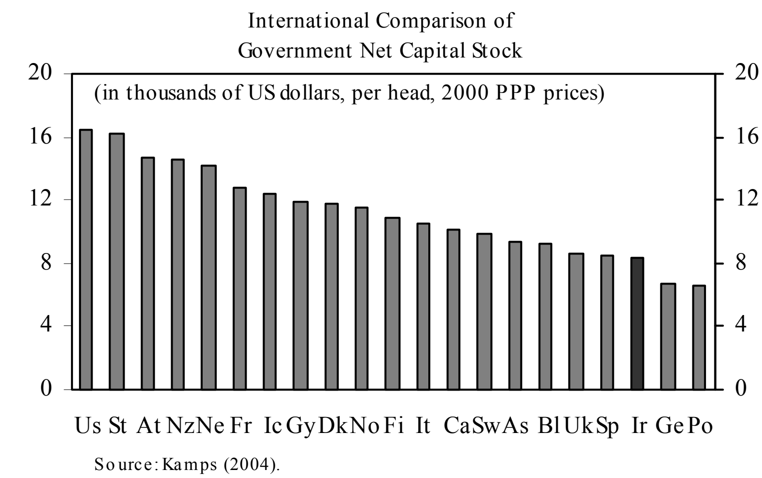
Source: Department of Finance; staff calculations.

26. **The staff argued that cyclical considerations presented a strong case for beginning the required modest longer-run fiscal tightening in the next budget.** The authorities emphasized their commitment to the SGP, including achieving a zero structural balance over the medium term, which the staff fully supports. The projected structural balances in the 2004 Stability Program are in line with commitments under the SGP and would maintain sufficient margin against the risk of breaching the 3 percent of GDP deficit limit. Given staff's estimate of this year's underlying deficit of ½ percent of GDP, a modest adjustment would be required over the next few years to reach this target. From a cyclical perspective, with growth picking up, little spare capacity in the economy and the possibility of a larger-than-expected slowing in the property market that could lower stamp duty and capital gains revenues significantly, the staff argued there was a strong case for beginning adjustment in the next budget. From a longer perspective, fiscal policy should be well placed to deal with the pressures from aging. The build-up of assets in the National Pension Reserve Fund (annual contribution of 1 percent of GNP) will help alleviate the budgetary cost of aging. Also, Ireland is in a comparatively good position to meet these costs given the high degree of pension funding and the relatively low tax burden.

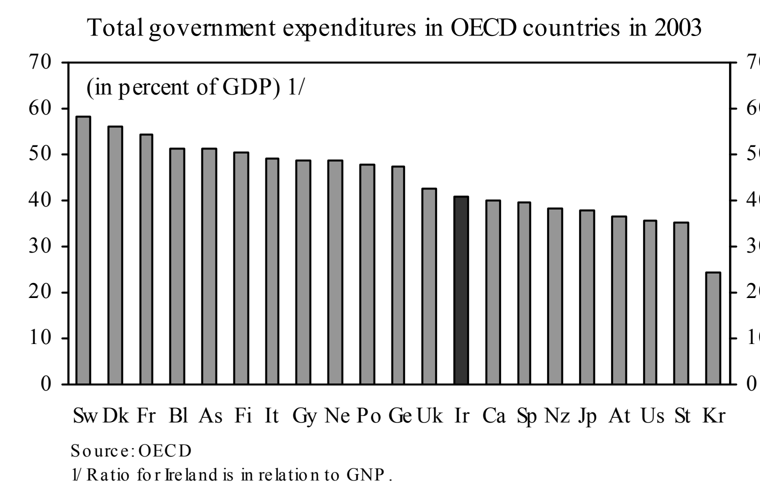
Cyclically-adjusted Fiscal Balances in Stability Programmes (SP)
(in percent of potential GDP)



27. **But political pressures to reduce taxes or spend the recent improvements in the public finances are likely to grow, especially in the event of upside surprises to growth, and staff called for an overall multi-year spending framework.** There was agreement that any loosening of fiscal policy at this juncture would be procyclical, with deleterious effects on inflation, value for money in government expenditures and competitiveness. In line with the staff's calls in the past, the authorities extended the use of rolling multi-year spending envelopes from the transportation sector to all public capital spending in the last budget. Multi-year spending envelopes limit the potential for procyclical expenditure changes, increase the predictability and transparency of expenditure policy, improve planning and management of expenditures and thereby encourage efficiency. Staff urged that these be extended to encompass current spending. The authorities viewed the need for expectations to adjust completely to the lower medium-term growth prospects as a necessary precondition for adopting medium-term spending envelopes well-aligned to perspective resource growth.



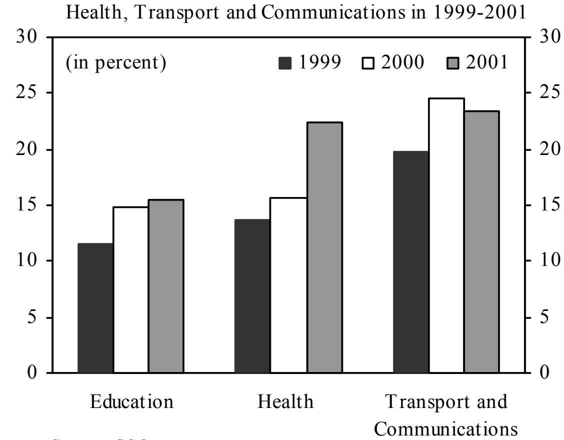
28. **The mission agreed with the authorities' view that meeting the demand for higher quality public services and infrastructure does *not* require higher taxes and spending.** The size of government is *not* small in comparison with other OECD countries when compared to GNP, the more relevant measure of domestic economic activity in Ireland. Lower tax rates in Ireland as compared to the EU reflect favorable demographics that require substantially lower social security taxes, prudent fiscal policies that have delivered lower debt and debt-servicing costs, smaller defense requirements and lower unemployment-related social spending. Government



capital spending, at the targeted 5 percent of GNP, is well above levels elsewhere. Faster increases risk running up against bottlenecks and serious inefficiencies, as in the late 1990s when spending exceeded this level, leading to double digit rates of associated price inflation.

29. **Providing higher quality public services requires improving the value for money in public expenditures.** Popular dissatisfaction with the quality of public services in health, education and infrastructure runs high despite double-digit rates of growth, suggesting significant expenditure inefficiencies or inadequate information on outputs. The authorities have taken a number of initiatives to improve the efficiency and control of expenditures, including monthly reviews of departmental expenditures, new guidelines to improve the management and appraisal of capital projects, and better contractual arrangements for construction projects that shift risks to contractors. The authorities noted the fundamental reform of administrative structures begun in the health sector which would foster accountability and rationalize service provision, and the program for the modernization of public service delivery. Staff argued for shifting the focus in public services delivery from inputs to outputs. In particular, an emphasis on quantified performance targets would motivate efficiency gains, while demonstrable improvements in the quality of public services will be necessary over time to reduce pressures for additional spending increases, arguing for better monitoring and measurement of public outputs.

Nominal Growth Rates in Spending on Education, Health, Transport and Communications in 1999-2001



Source: CSO

E. Other Issues

30. **Ireland's statistics are being improved to meet international requirements.** Staff welcomed the newly-introduced data on external debt and stressed the need to improve fiscal reporting at the general government level and to publish a national earnings index as well as sectoral balance sheets. The authorities are extending the scope and consistency of earnings data and compiling sectoral balance sheets, which should be completed by 2005.

31. **Ireland has been a strong supporter of trade liberalization in the context of the EU.** On the CAP, however, the authorities noted that having agreed to two reforms in preparation for the WTO they were unlikely to agree to further reforms. They noted that the priority is to ensure a balanced agreement in agriculture across the three pillars of domestic support, market access and export subsidies. They feel agriculture is one element of the negotiation of a new WTO round that should not be sacrificed as the price for an overall agreement.

32. **The authorities remain committed to reaching the UN target of 0.7 percent of GNP for official development assistance (ODA) by 2007**. As in 2003, ODA is budgeted at 0.4 percent of GNP in 2004.

III. Staff Appraisal

33. **In the face of substantial global shocks over the last few years, the economic performance of Ireland has been enviable.** Despite being one of the most open economies in the world, growth proved remarkably resilient to the global downturn. Contrary to concerns, flexibility in the labor market limited increases in unemployment. After running well above trading partner country rates for several years, aided by the euro's appreciation, inflation slowed rapidly, converging to euro area rates.

34. **The near-term prospect is for stronger and broader-based growth and for inflation to remain moderate.** Growth will be supported by external demand and a continued rebound in business investment but private consumption will be restrained by increases in debt servicing costs as interest rates begin to normalize and residential investment should slow from unusually high rates. Underlying or core inflation should remain in the vicinity of 2 percent though headline rates will be buffeted by oil prices. The potential for further euro appreciation in response to global imbalances and an abrupt unwinding of the housing boom represent key risks to the outlook.

35. **Medium-term growth prospects are markedly lower than experienced in the second half of the 1990s.** Many of the one-off factors that accounted for the 1990s boom have raised the level of output rather than imparted a lasting influence on growth prospects and staff forecasts medium-term growth of 4½ percent in GNP. Such rates remain amongst the highest in the world but are less than half the average experienced in 1995–2000.

36. **The key challenge for both the private and public sectors is managing the transition, in particular of expectations, to slower growth.** Indeed, the external downturn helped initiate a necessary adjustment of expectations and policies to lower growth. However, with medium-term growth prospects significantly lower and the economy not operating far from potential, it is important that these adjustments be viewed as required for longer-term structural reasons rather than as having been necessary for cyclical reasons only. From this vantage point, there are varying degrees of concern about the adjustments to date across sectors.

37. **Safeguarding competitiveness must be a key priority of economic policy and the social partnership.** In goods and labor markets, the deceleration of inflation indicates expectations have been adjusting but the lagged response means the level of competitiveness has deteriorated significantly. Wage and goods-price inflation rates persistently in excess of those in partner countries represented in part a warranted catch-up as incomes and productivity rose. This process has to, however, be near completion if it has not already overshot. Ireland's price level has risen well above that in its main trading partners and wages are now amongst the highest in the world. The wage increase negotiated recently by

the social partnership is in line with prospective core inflation and productivity developments. It does not, however, take into account past erosions in the level of competitiveness or the risks of further euro appreciation. An extended period of wage restraint is therefore warranted. The desirability of increased wage flexibility also provides a case for shortening the duration of national wage agreements from three years. The costs of more frequent negotiations can be reduced by separating wider social partnership issues from the wage negotiation process.

38. **At this conjuncture, public policy should aim to engineer a soft landing in the housing market, but over the medium-term reforms will need to improve the stability of the sector.** As house price increases continue to exceed reasonable prospects for medium-term growth, the Central Bank's communications to tame expectations in both the credit and housing markets are appropriate and welcome. In the event of an abrupt unwinding of the housing market boom, though financial stability is likely not a concern, there is a likelihood of a protracted slowdown in private consumption. With variable rate mortgages predominant and household debt levels having risen, more can and should be done to increase borrower and lender awareness of the prospects for interest rate increases from current cyclical lows and their implications for debt-servicing costs. The strong preference in Ireland for owning property is a compelling reason for *not* providing additional incentives in the form of subsidies to home ownership. Removing the interest-deductibility of mortgage payments on primary dwellings and introducing a market-value-based wealth tax on property is therefore important. Given still scarce infrastructure, second homes should be taxed at higher rates.

39. **Fiscal policy has adjusted well to slower medium-term growth prospects, but cyclical considerations argue for frontloading the remaining necessary longer-run consolidation.** The 2003 Budget began the process of adjusting to the new growth realities and the 2004 Budget has held the line, with planned expenditure growth within typical ranges of medium-term potential nominal GDP growth. The overall outturn for 2003 and early returns in 2004 have exceeded expectations, but this reflects in part windfall receipts from changes in the capital-gains tax regime and successes with anti-fraud measures, as well as higher-than-expected revenues from the buoyancy of the property market. Excluding these one-off effects, there is an underlying deficit in 2004 of ½ percent of GDP. With limited slack in the economy and growth picking up, the required adjustment to the medium-term objective of balance should begin in Budget 2005. Political pressures to spend the improvement in the public finances should be resisted as such an easing would be procyclical, raise inflation, hurt competitiveness, and limit the value for money from such expenditures.

40. **Concerns about the level and quality of public services and infrastructure in Ireland should be addressed by improving delivery rather than by raising taxes and expenditures.** At its present levels of 5 percent of GNP, government capital spending is well above levels elsewhere, and faster increases would risk running up against bottlenecks and inefficiencies. The introduction of multi-year spending envelopes for department's public capital spending is particularly welcome because it should safeguard such spending from procyclical pressures, improve planning and predictability, and encourage efficiency. There

is a strong case for extending such envelopes speedily to encompass current spending. The fundamental reforms begun in the health sector and the modernization of public service delivery hold promise. There should be a shift in focus across public services from inputs to outputs.

41. **Scope remains for improving the provision of statistics**. Ensuring the timeliness of general government accounts and developing a national earnings index should be priorities.

42. **The authorities should adopt a more supportive stance within the EU in favor of further CAP reform**, particularly in view of the adverse impact of this policy on developing countries and EU consumers. This would complement the welcome commitment towards achieving the UN's ODA target by 2007.

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

Table 1. Ireland: Selected Economic Indicators, 2000-05
(Annual change unless otherwise stated)

	2000	2001	2002	2003	2004 Proj.	2005 Proj.
National accounts (constant prices) 1/						
GNP	10.1	3.8	1.5	2.8	4.5	5.0
GDP	9.9	6.0	6.1	3.7	4.7	5.0
Domestic demand	9.1	3.8	3.4	3.3	3.3	3.6
Private consumption	9.0	5.5	2.8	2.6	3.2	3.8
Public consumption	8.0	10.9	8.6	2.5	2.2	2.3
Gross fixed investment	7.3	-1.6	3.0	3.4	5.1	4.0
Net exports (contribution to GDP growth)	2.2	2.8	3.1	1.2	2.0	1.3
Exports of goods and services	20.4	8.4	5.7	-0.8	5.0	4.9
Imports of goods and services	21.3	6.7	3.3	-2.3	3.8	4.6
Prices, wages and employment						
Harmonized Index of Consumer Prices (annual average)	5.2	4.0	4.7	4.0	2.3	2.1
Average hourly earnings , manufacturing	6.2	10.3	8.5	5.5	...	...
Output, manufacturing 2/	15.7	10.2	8.4	6.4	...	...
Unit wage costs (manufacturing) 2/	-4.7	-2.6	-8.9	-4.8	...	...
GNP/Employment	5.0	0.6	-0.3	0.9	3.0	3.5
Employment	4.8	3.1	1.8	1.9	1.5	1.5
Unemployment rate (in percent)	4.3	3.9	4.4	4.7	4.4	4.1
Money and credit (end-period)						
M3 3/	14.7	17.2	9.3	9.6	8.3 6/	...
Private sector credit 4/	21.3	15.1	15.0	17.9	24.8 6/	...
Financial and asset markets (end-period)						
Three-month treasury bill	4.8	3.3	2.9	2.1	2.1 7/	...
10-year government bond	5.1	5.1	4.3	4.3	4.2 7/	...
ISEQ index	14.0	-0.3	-30.0	23.2	21.4 7/	...
House prices (permanent tsb index/ESRI)	21.3	4.4	13.3	13.8	11.3 7/	...
Public finance (In percent of GDP)						
General Government Balance 5/	4.4	1.1	-0.2	0.2	-0.3	-0.5
Primary balance 5/	6.4	2.6	1.2	1.6	1.1	0.8
General government debt	38.3	35.9	32.7	33.2	32.5	32.0
External trade and balance of payments						
Balance of goods and services (Percent of GDP)	13.2	15.0	16.6	15.4	15.3	15.5
Current account (Percent of GDP)	-0.4	-0.7	-1.3	-1.4	-1.6	-1.3
Official reserves (In billions of SDRs, end-period.)	4.1	4.5	4.0	2.8	1.6 6/	...
Effective exchange rates (1995=100, annual average)						
Nominal	88.3	89.2	90.7	96.7	96.7 6/	...
Real (CPI based)	91.0	94.4	98.9	106.8	106.5 6/	...
Memorandum items for 2003						
Area	70.3 thousand square kilometers					
Population (in million)	4.0					
Natural rate of increase (percent change)	1.9					
GDP per capita (in SDRs)	28,792					

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/ Underlying productivity growth data may be overstated because of problems related to the measurement of output produced by multinational companies operating in Ireland.
3/ The methodology for calculation of Ireland's contribution to the Euro area money supply was amended in January 2000.
4/ Adjusted change, which includes the effects of transactions between credit institutions and non-bank international financial companies and valuation effects arising from exchange rate movements.
5/ Estimated prior to allocations for financing of future pensions liabilities and one-off expenditures, but including contingency provision for 2005.
6/ As of June 2004
7/ As of July 2004

Table 2. Ireland: Summary of Balance of Payments, 2000-07

	2000	2001	2002	2003	2004 Proj.	2005 Proj.	2006 Proj.	2007 Proj.
	(In millions of euro)							
Current account balance	-379	-757	-1,617	-1,894	-2,250	-2,077	-2,026	-2,344
Trade balance	27,266	30,493	35,443	33,421	35,996	39,272	42,311	45,630
Exports of goods	79,971	86,690	89,495	79,186	83,671	90,330	96,169	102,391
Imports of goods	-52,705	-56,197	-54,052	-45,765	-47,674	-51,058	-53,857	-56,761
Services	-13,656	-13,151	-14,250	-12,643	-13,861	-15,094	-16,208	-17,856
Credit	20,749	26,952	30,206	33,573	34,095	34,720	35,649	36,192
Debit	-34,405	-40,103	-44,456	-46,216	-47,955	-49,814	-51,857	-54,048
of which Royalties								
Credit	701	207	262	147	...	...	...	...
Debit	-9,051	-10,578	-10,991	-12,704	...	...	...	...
Balance on goods and services	13,610	17,342	21,193	20,778	22,136	24,178	26,104	27,774
Net factor incomes	-14,750	-18,295	-23,515	-23,112	-25,186	-27,117	-29,053	-31,107
Credit	30,089	32,228	27,835	28,086	...	...	...	...
Debit	-44,839	-50,523	-51,350	-51,198	...	...	...	...
Balance on goods, services and income	-1,140	-953	-2,322	-2,334	-3,050	-2,939	-2,950	-3,333
Current transfers (net)	994	305	707	440	801	862	924	989
Capital and financial account	9,602	384	425	1,828	...	...	...	...
Capital account balance	1,182	703	512	370	...	...	...	...
Financial account	8,420	-319	-87	1,458	...	...	...	...
Direct investment	22,957	6,242	21,796	20,684	...	...	...	...
Portfolio investment	-5,358	-25,158	-38,373	-49,114	...	...	...	...
Other investment	-9,037	19,039	19,287	21,078	...	...	...	...
Reserve assets	-142	-441	343	1,770	...	...	...	...
Net errors and omissions	-9,223	372	464	768	...	...	...	...
	(In percent of GDP)							
Memorandum items:								
Current account balance	-0.4	-0.7	-1.3	-1.4	-1.6	-1.3	-1.2	-1.3
Trade balance	26.5	26.4	27.7	24.8	24.8	25.2	25.3	25.5
Services	-13.2	-11.4	-11.1	-9.4	-9.6	-9.7	-9.7	-10.0
Net factor incomes	-14.3	-15.8	-18.4	-17.1	-17.4	-17.4	-17.4	-17.4
Balance on goods, services and income	-1.1	-0.8	-1.8	-1.7	-2.1	-1.9	-1.8	-1.9
Transfers	1.0	0.3	0.6	0.3	0.6	0.6	0.6	0.6

Sources: The Central Statistics Office; and staff estimates.

Table 3. Ireland: Contribution to GDP Growth, 2000-05
(In percent) 1/

	2000	2001	2002	2003	2004 Proj.	2005 Proj.
Domestic demand	7.8	3.2	2.9	2.7	2.7	2.9
Private consumption	4.6	2.8	1.4	1.3	1.6	1.8
Public consumption	1.0	1.4	1.1	0.3	0.3	0.3
Fixed investment	1.6	-0.3	0.6	0.7	1.0	0.8
Structures	0.8	0.5	0.6	0.6	0.6	0.2
Residential investment	0.5	0.3	0.3	0.8	0.5	0.1
Equipment	0.9	-0.9	0.0	0.1	0.4	0.6
Change in stocks	0.6	-0.6	-0.2	0.4	0.0	0.0
Net exports	2.2	2.8	3.1	1.2	2.0	1.3
Exports	19.9	9.0	6.2	-0.8	5.2	5.1
Imports	-17.7	-6.1	-3.1	2.0	-3.2	-3.9
Statistical discrepancy	-0.1	-0.1	0.1	-0.2	0.1	0.0
GDP (annual percent change)	9.9	6.0	6.1	3.7	4.7	5.0
GNP (annual percent change)	10.1	3.8	1.5	2.8	4.5	5.0
Memorandum item:						
Current account (as a percent of GDP)	-0.4	-0.7	-1.3	-1.4	-1.6	-1.3

Source: Staff estimates.
1/ Rounding may affect totals.

Table 4. Ireland: General Government Finances, 1991-2004
(In percent of GDP)

	1999	2000	2001	2002	2003	Proj. 2004
Current balance	6.9	8.0	5.5	3.9	3.9	3.4
Current revenue, of which	34.7	34.6	32.9	32.0	33.0	33.1
Tax revenue (including taxes on capital)	27.1	26.9	25.0	24.3	25.1	25.4
Social security receipts	4.1	4.2	4.3	4.3	4.4	4.4
Miscellaneous	3.5	3.5	3.6	3.4	3.5	3.3
Current expenditure, of which	27.8	26.6	27.4	28.1	29.1	29.7
Interest payments	2.5	2.0	1.5	1.4	1.4	1.4
Goods and services	5.2	5.2	5.4	5.9	5.9	5.9
Compensation of employees	8.1	8.0	8.4	8.3	8.6	8.9
Current transfers	11.3	10.7	11.3	11.7	12.3	12.4
Depreciation	0.7	0.7	0.8	0.8	0.9	1.0
Current expenditure, excluding interest and transfers	14.0	13.9	14.5	15.0	15.5	15.8
Capital balance 1/	-4.4	-3.6	-4.5	-4.1	-3.7	-3.7
Capital receipts (excluding taxes on capital)	1.4	1.1	1.2	1.2	1.1	1.0
Gross capital formation	3.2	3.7	4.5	4.4	3.8	3.8
Capital transfers 1/	2.7	1.1	1.2	0.9	0.9	0.9
General government balance 1/	2.5	4.4	1.1	-0.2	0.2	-0.3
Primary balance	4.9	6.4	2.6	1.2	1.6	1.1
Memorandum items:						
Structural (as a percent of potential GDP):						
Revenue 2/	36.0	35.6	34.0	33.1	34.1	34.0
Expenditure	35.1	33.4	34.7	34.9	33.6	34.3
Government balance	0.9	2.2	-0.7	-1.8	0.5	-0.2
Primary balance	3.4	4.2	0.8	-0.4	1.9	1.2
General government gross debt (as percent of GDP)	48.7	38.3	35.9	32.7	33.2	32.5
Growth in nominal GDP	15.3	15.2	12.0	10.9	5.3	7.5

Sources: Department of Finance and staff estimates.

1/ Including a capital transfer related to the repayment of the government's pension liabilities with respect to An Post and Telecom Eireann of 1.8 percent of GDP in 1999.
2/ Revenues in 2002 exclude UMTS receipts of 0.2 percent of GDP.

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

	2003	2004	2005	2006	2007	2008	2009
			Staff Projections				
Total revenue	34.1	34.0	33.0	33.0	33.0	33.0	33.0
Taxes and social security contributions	29.5	29.7	28.9	29.0	29.0	29.0	29.0
Other revenue	4.6	4.3	4.1	3.9	3.9	3.9	3.9
Total expenditure	33.9	34.4	33.5	33.4	33.4	33.5	33.5
Primary expenditure, of which:	32.5	33.0	32.2	32.0	32.0	32.0	32.0
Gross fixed investment	3.8	3.8	3.9	3.8	3.8	3.8	3.8
Government consumption	15.5	15.8	15.5	15.7	15.7	15.7	15.7
Current transfers	12.3	12.4	12.0	11.6	11.6	11.6	11.6
Capital transfers	0.9	0.9	0.8	0.8	0.8	0.8	0.8
Interest payments	1.4	1.4	1.3	1.5	1.5	1.6	1.6
Budget balance	0.2	-0.3	-0.5	-0.5	-0.5	-0.5	-0.5
Memorandum:							
Nominal GDP growth in percent	5.3	7.5	7.7	7.1	7.1	7.1	7.2
Gross debt	33.2	32.5	32.0	31.6	31.3	31.1	30.8
Structural budget balance, including one-offs 2/	0.5	-0.2	-0.5	-0.5	-0.5	-0.5	-0.5
Structural budget balance, excluding one-offs 2/	0.1	-0.6	-0.5	-0.5	-0.5	-0.5	-0.5
Output gap	-0.5	-0.2	0.0	0.0	0.0	0.0	0.0
			Stability Program December 2003 Update				
Total revenue	34.1	33.5	32.9	32.5	...	...	...
Total expenditure	34.6	34.6	34.2	33.6	...	...	...
of which:							
Collective consumption	5.8	5.9	5.8	5.7	...	...	...
Individual consumption	10	10.2	10	9.9	...	...	...
Social transfers other than in kind	9.1	9.2	9.1	8.9	...	...	...
Gross fixed investment	3.9	3.8	3.9	3.8	...	...	...
Interest payments	1.5	1.4	1.4	1.4	...	...	...
Subsidies	0.6	0.6	0.6	0.6	...	...	...
Other	3.6	3.6	3.4	3.3	...	...	...
General government balance	-0.4	-1.1	-1.4	-1.1	...	...	...
of which due to contingency	...	...	0.4	0.8	...	...	...
Memorandum:							
Nominal GDP growth in percent	4.5	7.1	7.7	7.7	...	...	...
Gross debt	33.1	33.3	33.5	33.3	...	...	...
Structural budget balance 2/	-0.8	-0.5	-0.4	-0.1	...	...	...
Output gap	1.0	-1.5	-2.3	-2.3	...	...	...

Sources: Staff estimates and Department of Finance
1/ Based on current policies. The staff estimates assume that tax revenues will perform according to the latest SP projections in 2005–06, but are adjusted for the difference between the government's and staff's growth assumptions. From 2007 onwards, tax revenues (excluding indirect taxes) are projected using the OECD's estimates of tax elasticities. Expenditure estimates for 2004 are based on the latest available official information, whereas projections for 2005–06 assume expenditure to increase at the pace envisaged in the SP (except for interest rate expenditure). Due to different accounting conventions, the staff's estimates of total revenue and expenditure ratios differ from the Stability Programme.
2/ As a percent of potential GDP.

Table 6. Ireland: Indicators of External and Financial Vulnerability, 1999-2003
(In percent of GDP, unless otherwise indicated)

	1999	2000	2001	2002	2003
External Indicators					
Exports (annual percent change, value in U.S. dollars)	12.2	10.3	9.5	11.5	13.0
Imports (annual percent change, value in U.S. dollars)	9.3	12.8	7.1	8.3	12.0
Terms of trade (goods, annual percent change)	-2.5	-3.1	2.0	2.0	-0.5
Current account balance	0.3	-0.4	-0.7	-1.3	-1.4
Capital and financial account balance,	-1.8	9.3	0.3	2.4	2.2
Of which:					
Inward portfolio investment	71.2	81.4	86.0	58.3	69.2
Inward foreign direct investment	19.1	27.1	9.3	24.1	17.7
Other investment liabilities (net)	-1.1	-8.8	16.5	14.7	21.7
Total external debt 1/	2.8	2.0	1.8	0.6	0.0
Of which:					
External debt to exports ratio	4.0	2.6	2.4	0.8	0.0
External interest payments to exports (in percent)	0.3	0.2	0.1	0.2	0.0
US dollar per euro (period average)	1.07	0.92	0.89	0.94	1.13
UK £ per euro (period average)	0.66	0.61	0.62	0.63	0.69
Financial Markets Indicators					
General government debt	48.7	38.3	35.9	32.7	33.2
Government bond yield (10-year, end-period)	5.6	5.1	5.1	4.3	4.3
Spread of government bond yield with Germany (end of period)	0.6	0.2	0.6	0.2	0.3
Real government bond yield (10-year, period average, based on national CPI)	3.1	-0.1	0.1	0.3	0.6
Annual change in ISEQ index (in percent, end of period)	0.4	14.1	-0.3	-30.0	23.2
Personal lending interest rate	10.5	11.8	10.6	10.4	9.9
Variable mortgage interest rate	4.2	6.0	4.6	4.2	3.5
Financial Sector Risk Indicators					
Annual credit growth rates (to private sector)	21.3	21.3	15.1	15.0	17.9
Annual deposit growth rates	8.1	15.6	15.6	9.6	11.9
Personal lending as a share of total loans	53.7	52.1	52.2	55.3	55.6
(excluding financial intermediation and government)					
Of which:					
House mortgage finance	39.7	39.0	38.8	42.4	44.4
Other housing finance	0.9	1.0	0.9	0.8	0.4
Other personal lending	13.0	12.2	12.5	12.0	10.8
Annual mortgage credit growth rates	22.4	19.3	17.4	22.5	25.5
Commercial property lending as a percent of total loans					
(excluding financial intermediation) 2/	18.2	20.5	21.6	22.1	24.4
Foreign-currency denominated assets (in percent of total assets)	41.0	41.5	44.6	40.1	32.5
Foreign-currency denominated liabilities (in percent of total liabilities)	42.8	44.4	47.4	42.9	34.2
Contingent and off-balance sheet accounts (in percent of total assets) 3/	400.5	465.1	591.8	505.2	537.7
Non-performing loans (in percent of total loans) 4/	1.0	1.0	1.0	1.0	0.9
Total provisions for loan losses (in percent of total loans)	1.1	1.1	1.1	1.1	0.9
Risk-weighted capital/asset ratios of domestic banks (in percent)	10.8	10.7	10.6	12.3	13.9
Bank return on assets	1.3	1.2	0.9	1.0	0.9
Bank return on equity	23.0	22.0	16.0	18.0	17.8
Liquid assets of all banks to total assets (liquid asset ratio)	32.0	32.0	30.0	30.0	33.6
Liquid assets of all banks to short-term liabilities (in percent)	39.0	44.0	37.0	34.0	41.2
Deposits to M3 ratio 5/	1.03	1.03	1.02	1.02	1.04
Loan-to-deposit ratio vis-à-vis Irish residents 2/ 6/	1.29	1.36	1.44	1.43	1.46
vis-à-vis total 2/ 6/	1.47	1.54	1.59	1.51	1.56
Concentration ratios in the banking sector					
No. of banks accounting for 25 percent of total assets	3	3	3	3	2
No. of banks accounting for 75 percent of total assets	23	23	21	19	18
Share of state-owned banks in total assets	3	2	1	0	0
Share of foreign-owned banks in total assets	37	39	42	29	31

Sources: Data provided by the authorities; Central Bank of Ireland; International Financial Statistics; Bloomberg; and staff calculations.
1/ Represents non-euro debt of the government sector.
2/ Includes lending for construction, hotels and restaurants, and real estate activities.
3/ Credit equivalent values.
4/ Owing to differences in classification, international comparisons of non-performing loans are indicative only.
5/ Non-government deposits vis-à-vis Irish and non-residents to M3 ratio.
6/ Non-government loans/non-government deposits ratio.

Fund Relations
(As of June 30, 2004)

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

II. **General Resources Account:**	**SDR Million**	**% Quota**
Quota	838.40	100.00
Fund holdings of currency	535.53	63.88
Reserve position in Fund	302.89	36.13
Holdings Exchange Rate		

III. **SDR Department:**	**SDR Million**	**% Allocation**
Net cumulative allocation	87.26	100.00
Holdings	55.18	63.23

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

V. **Financial Arrangements:** None

VI. **Projected Payments to the Fund**

(SDR Million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2004	2005	2006	2007	2008
Principal					
Charges/Interest	0.29	0.59	0.59	0.59	0.59
Total	0.29	0.59	0.59	0.59	0.59

VII. **Exchange Arrangement**

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

VIII. **Article IV Consultations**

The discussions for the last Article IV consultation were conducted in Dublin during May 6–15, 2003. The staff report (Country Report No. 03/242) was considered by the Executive Board on July 30, 2003 (EBM/03/75). Article IV consultations with Ireland are currently on the standard 12-month cycle.

IX. **Technical Assistance:** None

X. **Resident Representative:** None

Sustainability Exercise

Fiscal Sustainability

The sustainability of Ireland's fiscal position was assessed under alternative scenarios regarding key macroeconomic and fiscal assumptions, as well as several bound tests (Table A1). In the baseline, gross general government debt declines gradually from about 34 percent in 2003 to slightly below 31 percent in 2009. This occurs despite continued increases in assets, such as those accumulated in government pension and social security funds.[8] The primary balance remains in surplus during the period, leading to a favorable medium-term fiscal outlook.

The alternative scenarios and bound tests show that Ireland's medium-term fiscal debt position is resilient to a variety of shocks (see panels A and B of Table A1). The worst outcome—a rise in the debt ratio from 32½ percent in 2004 to around 40 percent in 2009—is achieved under the assumption that there is a 10 percent of GDP increase in other debt-creating flows in 2005.

External Sustainability

With a net external position (excluding direct investment) showing substantial claims on the rest of the world (around 90 percent of GDP), external debt sustainability does not seem to be an issue (Table A2). The net external position, including direct investment, is in a relatively small deficit given the very strong continued FDI inflows into Ireland. The fact that Ireland is a net creditor with regard to portfolio suggests little vulnerability to interest rate shocks or to a sudden reversal in short-term capital flows. The large gross assets and liabilities in portfolio and other investments reflect the activities of the International Financial Service Center, which the 2000 FSAP noted does not appear to pose a systemic risk to the domestic financial system.

[8] These items are included in the category "other identified debt-creating flows."

Table A1. Ireland: Public Sector Debt Sustainability Framework, 1999-2009
(In percent of GDP, unless otherwise indicated)

	Actual							Projections					
	1999	2000	2001	2002	2003			2004	2005	2006	2007	2008	2009
								I. Baseline Projections					
1 **Public sector debt 1/**	48.7	38.3	35.9	32.7	33.2			**32.5**	**32.0**	**31.6**	**31.3**	**31.1**	**30.8**
2 Change in public sector debt	-5.1	-10.4	-2.4	-3.2	0.5			-0.7	-0.5	-0.4	-0.3	-0.3	-0.2
3 Identified debt-creating flows (4+7+12)	-9.6	-10.8	-5.2	-3.3	-1.9			-2.0	-1.8	-1.7	-1.6	-1.6	-1.5
4 Primary deficit	-4.9	-6.4	-2.6	-1.2	-1.6			-1.1	-0.8	-1.0	-1.0	-1.0	-1.0
5 Revenue and grants	36.1	35.7	34.1	33.2	34.1			34.0	33.0	33.0	33.0	33.0	33.0
6 Primary (noninterest) expenditure	31.2	29.3	31.5	32.0	32.5			33.0	32.2	32.0	32.0	32.0	32.0
7 Automatic debt dynamics 2/	-4.7	-4.4	-2.6	-2.1	-0.3			-0.9	-1.0	-0.7	-0.6	-0.5	-0.5
8 Contribution from interest rate/growth differential 3/	-4.7	-4.4	-2.6	-2.1	-0.3			-0.9	-1.0	-0.7	-0.6	-0.5	-0.5
9 Of which contribution from real interest rate	0.5	-0.2	-0.5	-0.1	0.9			0.6	0.5	0.7	0.7	0.8	0.8
10 Of which contribution from real GDP growth	-5.2	-4.2	-2.1	-2.0	-1.1			-1.5	-1.5	-1.4	-1.3	-1.3	-1.3
16 Residual, including asset changes (2-3)	4.5	0.5	2.8	0.1	2.3			1.3	1.3	1.3	1.3	1.3	1.3
Public sector debt-to-revenue ratio 1/	134.8	107.2	105.4	98.6	97.4			95.5	96.9	95.9	95.0	94.2	93.5
Gross financing need 4/	-2.5	-4.4	-1.1	0.2	-0.2			0.3	0.5	0.5	0.5	0.5	0.5
in billions of U.S. dollars	-2060.9	-4886.7	-1371.0	271.2	-247.6			410.5	630.5	632.3	681.4	821.7	895.3
Key Macroeconomic and Fiscal Assumptions						10-Year Historical Average	10-Year Standard Deviation						
Real GDP growth (in percent)	11.1	9.9	6.0	6.1	3.7	8.0	2.5	4.7	5.0	4.5	4.5	4.5	4.5
Average nominal interest rate on public debt (in percent) 5/	5.3	4.8	4.5	4.5	4.4	5.6	1.0	4.6	4.4	4.9	5.0	5.3	5.4
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	1.5	0.0	-1.1	0.0	2.8	1.8	2.1	1.9	1.9	2.4	2.5	2.8	2.9
Nominal appreciation (increase in US dollar value of local currency, in percent)	5.3	15.5	3.1	-5.1	-16.5	0.6	8.8	-8.2	0.2	-0.1	-0.2	-0.2	-0.2
Inflation rate (GDP deflator, in percent)	3.8	4.8	5.7	4.5	1.6	3.8	1.7	2.7	2.5	2.5	2.5	2.5	2.5
Growth of real primary spending (deflated by GDP deflator, in percent)	13.7	3.4	13.8	7.8	5.4	6.7	4.0	6.2	2.6	3.9	4.3	4.5	4.5
Primary deficit	-4.9	-6.4	-2.6	-1.2	-1.6	-4.0	1.8	-1.1	-0.8	-1.0	-1.0	-1.0	-1.0
								II. Stress Tests for Public Debt Ratio					
A. Alternative Scenarios													
A1. Key variables are at their historical averages in 2005-09 6/								**32.5**	**27.9**	**23.6**	**19.4**	**15.5**	**11.7**
A2. No policy change (constant primary balance) in 2005-09								**32.5**	**31.7**	**31.3**	**30.9**	**30.6**	**30.3**
A3. Country-specific shock in 2005, with reduction in GDP growth (relative to baseline) of one standard deviation 7/								**32.5**	**32.0**	**31.6**	**31.3**	**31.1**	**30.8**
A4. Selected variables are consistent with market forecast in 2005-09								**32.5**	**32.0**	**31.6**	**31.3**	**31.1**	**30.8**
B. Bound Tests													
B1. Real interest rate is at historical average plus two standard deviations in 2005 and 2006								**32.5**	**33.2**	**34.0**	**33.6**	**33.3**	**33.1**
B2. Real GDP growth is at historical average minus two standard deviations in 2005 and 2006								**32.5**	**33.3**	**34.6**	**35.3**	**36.2**	**37.0**
B3. Primary balance is at historical average minus two standard deviations in 2005 and 2006								**32.5**	**32.4**	**32.5**	**32.2**	**31.9**	**31.7**
B4. Combination of 2-4 using one standard deviation shocks								**32.5**	**31.1**	**29.7**	**29.4**	**29.1**	**28.9**
B5. One time 30 percent real depreciation in 2005 8/								**32.5**	**32.0**	**31.6**	**31.3**	**31.1**	**30.8**
B6. 10 percent of GDP increase in other debt-creating flows in 2005								**32.5**	**42.0**	**41.4**	**40.9**	**40.5**	**40.1**

1/ Gross general government debt. Although official figures for net government debt are not available, its level is considerably lower given the accumulation of assets, such as the National Reserve Fund.
2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).
3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi (1+g)$ and the real growth contribution as -g.
4/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
5/ Derived as nominal interest expenditure divided by previous period debt stock.
6/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.
7/ The implied change in other key variables under this scenario is discussed in the text.
8/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Table A2. Ireland: Net Investment Position
(In percent of GDP)

	1998	1999	2000	2001	2002
Assets	469	611	658	727	684
Direct investment abroad	22	28	29	34	26
Portfolio investment abroad	211	315	354	428	421
Other investment abroad	227	262	269	260	233
Reserve assets	8	6	6	6	4
Liabilities	443	559	661	745	708
Direct investment to Ireland	69	81	124	142	138
Portfolio investment to Ireland	182	251	301	347	322
Other Investment to Ireland	192	227	236	257	248
Net investment position	26	52	-3	-18	-23
Direct investment abroad	-46	-53	-94	-108	-112
Portfolio investment abroad	30	64	53	80	100
Other investment abroad	34	35	33	4	-15
Reserve assets	8	6	6	6	4
Net investment position, excluding direct investment	72	105	91	90	89

Source: CSO.

Statistical Issues

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

1. Quarterly national accounts on an ESA 1995 basis have been introduced and are currently published within 4 months of its reference period. Real sector data are sometimes published with a lag of 3–6 months, while some non-SDDS series are published with a lag of one and a half years (e.g., household disposable income). Lags are particularly long (3–7 months) for employment, earnings, unit wage costs, and national income and expenditure data. Ireland does not have an overall earnings index or comprehensive sectoral balance sheet data.

2. While the authorities publish Exchequer returns on a monthly and quarterly basis, only annual data on the general government balance are currently available.

Core Statistical Indicators
(As of August 12, 2004)

	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 Debt	GDP/ GNP
Date of Latest Observation	8/12/2004	June 2004	June 2004	June 2004	June 2004	8/12/2004	July 2004	May 2004	1st Quarter 2004	2003	1st Quarter 2004	1st Quarter 2004
Date Received	8/12/2004	7/30/2004	7/30/2004	7/30/2004	7/30/2004	8/12/2004	8/12/2004	7/30/2004	7/1/2004	3/4/2004	7/1/2004	7/1/2004
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	CSO	CSO
Monthly Reporting	Internet	Internet	Internet	Internet	Internet	Internet	Internet / Publication	Internet / Publication	Internet / Publication	Internet	Internet/ Publication	Internet/ Publication
Confidentiality	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public
Frequency of Publication	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Quarterly	Biannual	Quarterly	Quarterly

Statement by Charles X. O'Loghlin, Alternate Executive Director for Ireland
October 29, 2004

Key Points

- ***My authorities broadly share the analysis and conclusions of the well-balanced Staff Report.***
- ***The Irish economy has proved remarkably resilient to the global downturn, with growth well above the EU average through 2002/03 and strengthening more recently.***
- ***To sustain this performance going forward, my authorities:***
  - ***agree that safeguarding competitiveness is essential;***
  - ***are committed to managing public expenditure within the overall constraint of growth in current resources, and welcome the staff assessment that fiscal policy has adjusted to slower medium-term growth prospects; and***
  - ***are alive to the potential implications of strong house-price and household credit growth.***
- ***My authorities agree that the medium-term growth potential of the economy – with continuing economy-wide commitment to sound policies – is in the 4-5 percent range and note that, in the context of prospective population growth, this suggests annual per capita growth potential in the 3-3 ½ percent range.***

My authorities thank the staff for this year's positive Article IV discussions and Report…

1. At the outset, my authorities wish to thank the staff for the conciseness and sharp focus of this year's Article IV discussions – mirrored in their Report and in the accompanying Selected Issues document. **They broadly share the analysis and conclusions of the well-balanced Staff Report**.

Policy has generally paralleled past Fund advice…

2. In common with many Article IV Reports this year, the staff provides an assessment of the consistency of policy with their past advice. The considerations which underlay their recommendations in Reports over the past year or two were also foremost in the minds of Irish policy-makers as global and domestic growth faltered. It is, therefore, no surprise that policy developments over recent times, as indicated in Paragraph 7 of the Report, largely coincided with those recommendations.

Near-term economic prospects are encouraging…

3. Economic performance through this year has been significantly exceeding our expectations as 2004 began. My authorities now anticipate full-year GDP growth of the order of 4¾ percent (GNP 4¼ percent). A balanced budget is foreseen, rather than the 1.1 percent of GDP fiscal deficit initially forecast, underpinning a further fall in Ireland's already-low debt ratio. Despite some strengthening in personal consumption and the

significant imports associated with recovering machinery and equipment investment – adding further to Irish output capacity – the balance on our external current account is expected to show little change, with exports picking up in line with growth in world trade. **Overall, the Irish economy has proved remarkably resilient to the global downturn, with growth remaining well above the corresponding EU averages through 2002/03 and strengthening more recently**.

Aided by a continuing focus on competitiveness and bringing inflation down…

4. Indications are that employment will expand by about 2 percent through 2004. Despite this, unemployment is expected to ease only slightly from last year's level of 4.6 percent, reflecting ongoing net inward migration and – encouragingly – further increases in labor force participation. Still more encouraging, this progress is taking place in the context of a significant easing of EU-HICP-measured inflation, which should average about 2¼ percent this year – not far from the prospective euro area average for 2004. I might add that this improvement does not reflect (budget-damaging) easing of indirect taxes: net excise changes in Budget 2004 broadly approximated consumer price inflation. Instead, ongoing efforts to enhance competition in domestic markets and the wage provisions of the current social partnership agreement are key factors in the moderating pace of domestic cost increases, with the appreciating euro also playing a role.

My authorities agree that safeguarding competitiveness is essential going forward…

5. The staff provides an interesting assessment of competitive developments in the manufacturing sector. My authorities do not demur from its thrust – the strong output growth per labor-hour in a few technologically modern sectors[1] needs to be carefully interpreted in assessing manufacturing, or economy-wide, competitiveness. Different approaches to discounting this effect will offer differing assessments of competitiveness trends. However, my authorities would agree that all reasonable interpretations point to competitive loss over recent times.

Through a strong focus on cost developments…

6. They fully accept that Ireland cannot afford to worsen an already-deteriorated competitive position. This was a *key* focus of discussions on the current social partnership agreement – the outcome of which, as the staff note, "is in line with prospective core inflation and productivity developments". My authorities are insistent that, as a minimum, wage increases must be limited to those recently negotiated; and that regaining lost competitiveness must be a key priority of economic policy and of Social Partnership going forward. As to the suggestion to (permanently) move to shorter-

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[1] Measured labor productivity growth in these sectors reflects both (a) increases in labor efficiency in existing businesses and (b) the "birth" of new, *more* capital-intensive and *higher*-labor-productivity, businesses. Many of the latter reflect FDI flows – notably from the US – pushing measured labor productivity in those sectors towards US levels [e.g. O'Mahony & van Ark, quoted by the staff, report labor productivity in Ireland in Office Machinery and Electronic valves etc. at 40-60 percent above EU averages, but 10-20 percent below US levels, in 2001]. An employment-weighted interpretation of output-per-labor-hour largely adjusts for this effect – and takes substantial account, also, of developments in capital intensity [the US Bureau of Economic Analysis reports that total assets employed per worker in Irish-based (non-banking) affiliates of US entities in 2002 were 2¾ times the level of assets per person employed in the average EU15-based affiliate].

duration wage components in social partnership agreements[2], they recognize the merits of achieving greater wage flexibility but also note the significant logistical and practical difficulties associated with more frequent negotiations, and the heavy burden this would place on the social partnership process.

And on enhancing competitive forces, in particular to bear down on services costs…

7. My authorities' ongoing efforts to enhance competition in product and services markets aim in the same direction. With a few exceptions, product markets are exposed to strong competition – given Ireland's openness to imports: the exceptions are being narrowed gradually, not least under the aegis EU-wide deregulation of utilities markets. The focus of domestic effort, therefore, is on markets for "non-traded" services. These efforts are being given strong impetus by a growing public realization that Irish prices have caught up with, and passed, EU averages – an awareness bolstered by the ease with which individual and overall price levels can be contrasted in a common currency area.

Supported by a fiscal policy consistent with slower medium-term growth prospects…

8. The staff notes that the size of government in Ireland is *not* small in comparison with other OECD countries. My authorities agree that concerns about the level and quality of public services and infrastructure should be addressed by improving the efficiency and effectiveness of delivery rather than by raising tax and expenditure ratios. Apart from contributing to public welfare in the shorter run, they view this approach, also, as a crucial element in fully realizing Irish growth potential. **They are committed to managing public expenditure within the overall constraint of growth in current resources, and welcome the staff assessment that fiscal policy has adjusted to slower medium-term growth prospects**.

And a strong financial sector...

9. Ireland's sustained strong expansion of the past decade is testament to a robust, capable domestic banking system which, given continuing good health, is well-placed to support future economic expansion. In the light of rapid house-price and private sector credit growth, **it is appropriate to stress the staff conclusion that, even "in the event of an abrupt unwinding of Ireland's housing market boom, financial stability is likely not a concern"**. This parallels the view of our Central Bank and Financial Services Authority. At the launch of its recently-published "Financial Stability Report, 2004", my authorities noted that – based on extensive stress-testing – the shock-absorption capacity of the banking system is currently adequate, even in the face of a sudden and unanticipated fall in residential property prices accompanied by an increase in default rates. The capacity of the domestic banking system to withstand shocks without systemic stress, were they to arise, is bolstered by high profitability and strong capitalization. As to the risks of such an eventuality, the analyses reported by the staff give mixed signals

[2] My authorities note (with respect to page 51 of "Selected Issues") that the excess in actual pay changes over the wage terms of the various social partnership Agreements is attributable, in part, to the impact on average earnings of structural change – the replacement of lower-productivity employment by higher-productivity, thus higher-paying, jobs – rather than "slippage" versus the pay terms of those Agreements. It is difficult, however, to satisfactorily measure the extent of this effect.

on the question whether, and if so to what extent, house prices are overvalued relative to "the fundamentals". What is more certain in my authorities' view, however – as also suggested by the staff – is that if house prices were to continue to increase at the double-digit pace of recent times, the risk of a sharp correction would become more pronounced.

10. My authorities are not complacent. Work to strengthen the effectiveness of financial sector supervision continues apace (assisted by the recommendations of the 1999/2000 FSAP – which, it has been agreed with the Fund, will be revisited in the coming year). Likewise, efforts are ongoing to heighten the awareness of all economic agents – including mortgagors and mortgagees – of the potential implications of rising household indebtedness, especially in the context of the prevailing low interest rate environment. My authorities fully agree with the staff that "public communication can play an important role in taming expectations and help to induce a soft landing in the housing market".

Given these, the staff estimate of "potential growth after the boom" seems realistic…

11. Like the staff, my authorities have no illusions that Irish growth over the years ahead could sustainably emulate the unprecedented expansion of the 1990s. Several factors which contributed greatly to the "Celtic Tiger" performance *cannot repeat* in the future (certainly, at nowhere near the same pace, nor to anything like the same extent). No significant contribution to growth can be expected from further reducing unemployment, which is now around 4½ percent. The spectacular gains in labor force participation of recent years mean that space for future gains, while there, is far less than a decade ago. They also recognize that the prospective reversal of the hitherto declining trend in overall dependency – which allowed living standards to rise more rapidly than income-per-person-at-work during the "tiger" years – will slow *per capita* economic growth. **My authorities, therefore, agree that medium-term growth potential – with continuing economy-wide commitment to sound policies – is in the 4-5 percent range and that, in the context of prospective population growth, this points to annual *per capita* growth potential in the 3-3 ½ percent range.**

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

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

IMF Concludes 2004 Article IV Consultation with Ireland

On October 29, 2004, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Ireland.[1]

Background

Over the last half of the 1990s, incomes in Ireland converged quickly to the EU average owing to sustained expansions in output and employment. In the 1995–2000 period, growth averaged 10 percent a year while unemployment declined from almost 13 percent to below 4 percent. The fiscal position also strengthened considerably and the ratio of government debt to GDP fell from over 80 percent in 1995 to less than 40 percent in 2000. Strong export performance kept the current account in surplus or close to balance. Toward the end of the boom period, resource constraints tightened sharply and inflation accelerated to a peak of 6 percent in 2000.

In 2001, growth slowed sharply following the global downturn. Growth in GNP, which best reflects domestic economic activity because it excludes multinational profit flows, fell from 10 percent in 2000 to 1½ percent in 2002. While goods market activity slowed considerably, unemployment rose modestly to a peak of 4.8 percent in mid-2003. Inflation, although moderating slightly from its peak, remained well above the euro area average during the slowdown.

In 2003, the economy rebounded with GNP growing by almost 3 percent. Recent indicators suggest that activity has continued to strengthen in 2004. During 2003, inflation decelerated and

[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 October 29, 2004 Executive Board discussion based on the staff report.

is now close to the euro area average. Most recently, however, oil price increases have led to a mild pickup in inflation.

Monetary conditions have been accommodative for a sustained period as nominal interest rates declined considerably in the run-up to EMU. Further, with inflation in Ireland exceeding the euro area average until just recently, real interest rates declined even more. Low interest rates and financial market liberalization have resulted in a rapid expansion in household credit which combined with rapid growth in disposable incomes fuelled a boom in the housing market. Real house prices have risen by 187 percent since 1995.

The rapid economic expansion of the late 1990s increased fiscal revenues sufficiently to allow for substantial budget surpluses in spite of significant expenditure increases and tax cuts. Expenditure increases, however, failed to moderate as growth slowed in 2001 and the fiscal balanced slipped into deficit by 2002. In 2003, expenditure growth was lowered considerably and indirect taxes were increased, leading to a surplus of 0.2 percent of GDP.

Going forward, staff project that the economic recovery will gain momentum with GNP growth of 4½ percent in 2004 accelerating slightly to 5 percent in 2005. Core inflation is forecast to stay close to 2 percent. Although monetary conditions are expected to continue to be supportive, it is anticipated that interest rates will increase toward more normal levels as the global recovery firms. Over the medium term, real growth is expected to be in the 4 to 5 percent range.

Executive Board Assessment

Executive Directors commended the continued impressive performance of Ireland's economy, which is based on sound economic policies, providing useful lessons for other countries. Growth remained remarkably resilient in the face of substantial global shocks over the last few years. Flexibility in the labor market limited increases in unemployment, and inflation slowed rapidly, converging to euro area rates, after running well above trading partner country rates for several years. Looking ahead, as medium-term growth prospects are expected to be less buoyant than during the Celtic Tiger era of the 1990s, the key challenge for Ireland will be to manage the transition to slower growth.

In the near term, Directors expected the economic recovery to become stronger and broad-based, supported by external demand and a continued rebound in business investment. Core inflation is expected to remain moderate. The main risks to this outlook stem from the potential for further euro appreciation in response to global imbalances and the possibility of an abrupt unwinding of the housing boom.

In the medium term, Directors expected growth to be markedly lower than that experienced in the second half of the 1990s, as many of the factors that accounted for the 1990s boom were one-off in nature. However, at around 4-5 percent, growth will still remain high by international standards. The transition to slower growth will require adjustments in expectations in labor and housing markets, and also in fiscal policy. Directors stressed that while the global downturn helped initiate such adjustments, these should be viewed as required for longer-term structural reasons rather than for cyclical reasons only, and clear communications will remain important in this regard.

Directors concurred that safeguarding competitiveness should be a key priority of Ireland's economic policy and social partnership. Although inflation in goods and labor markets has decelerated—suggesting that expectations have adjusted to lower growth—the level of competitiveness has deteriorated. The outcome of the wage negotiations of the latest round of the social partnership, in line with prospective core inflation and productivity developments, is welcome. Nevertheless, Directors noted that the agreed increases do not take into account past erosions in the level of competitiveness or the risks of further euro appreciation. To address this potential source of vulnerability, Directors called for an extended period of wage restraint as well as for increased wage flexibility within the social partnership. This could be achieved by shortening the duration of national wage agreements from three years. Directors also noted that improving domestic competition, especially in the services sector, would help to contain input costs in the export sector.

Directors underscored the importance of achieving a soft landing of the housing market, given that recent house price increases continue to exceed medium-term growth prospects. While in the event of an abrupt unwinding of the housing market boom, financial stability would likely not be a concern, Directors cautioned that the impact of such an unwinding on employment and private consumption could be significant. They therefore welcomed the central bank's communications to curb expectations in credit and housing markets, and encouraged further efforts to increase borrower and lender awareness of the prospects for interest rate increases and their implications for debt-servicing costs. Many Directors also viewed the strong preference in Ireland for owning property as a compelling reason not to provide additional incentives in the form of subsidies to home ownership. Steps, which the authorities were advised to consider in a medium-term context, included removing the interest-deductibility of mortgage payments on primary dwellings, and introducing a market-value-based wealth tax on property, graduated to tax second homes at higher rates. Directors welcomed the authorities' continuing efforts to strengthen financial supervision, including by implementing the FSAP recommendations.

Directors concurred that fiscal policy has adjusted well to slower medium-term prospects. To avoid a procyclical fiscal policy, they called for a modest, front-loaded tightening in the structural fiscal balance in the next budget, in line with the authorities' commitment to achieve a structural balance over the medium term. Although the overall outturn for 2003 and early returns in 2004 have been better than expected, Directors noted that this performance is in part due to one-off receipts from changes in the capital-gains tax regime and successes with anti-fraud measures, and the buoyancy of the property market. It will therefore be important to resist political pressures for increased spending as a result of this improvement in public finances, as such an easing would be procyclical, raise inflation, hurt competitiveness, and limit value for money.

Directors shared the authorities' view that concerns about the level and quality of public services and infrastructure should be addressed by improving delivery rather than by raising tax and expenditure ratios. Directors welcomed the introduction of multi-year spending envelopes for departments' public capital spending. Ireland's government capital spending of 5 percent of GNP is already high by international standards and further increases would risk running up against bottlenecks and inefficiencies. The new framework should safeguard capital spending from procyclical pressures, improve planning and predictability, and encourage efficiency. Given these potential benefits, most Directors saw merit in extending the multi-year spending envelopes to cover current expenditures, as well. Directors supported the fundamental reforms begun in the health sector and the modernization of public service delivery, and encouraged a shift in focus across public services from inputs to outputs. They welcomed the ongoing efforts to strengthen budget controls and monitoring and to improve management and appraisal of capital projects. Directors considered Ireland well-placed to deal with the impact of population ageing, through both its sound fiscal position and the high degree of pension funding.

While commending the authorities' support of multilateral trade liberalization, Directors encouraged Ireland to adopt a more supportive stance within the EU in favor of further reform of the Common Agricultural Policy. They welcomed the authorities' commitment to raising official development assistance to attain the UN target of 0.7 percent of GNP by 2007.

Directors encouraged the authorities to continue their efforts on improving the provision of statistics.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

Ireland: Selected Economic Indicators

	2000	2001	2002	2003	2004 1/	
Real Economy (change in percent)						
Real GDP	9.9	6.0	6.1	3.7	4.7	
Real GNP	10.1	3.8	1.5	2.8	4.5	
Domestic demand	9.1	3.8	3.4	3.3	3.3	
Exports of goods and services	20.4	8.4	5.7	-0.8	5.0	
Imports of goods and services	21.3	6.7	3.3	-2.3	3.8	
HICP	5.2	4.0	4.7	4.0	2.3	
Unemployment rate (in percent)	4.3	3.9	4.4	4.7	4.4	
Public Finances (percent of GDP) 2/						
General government balance	4.4	1.1	-0.2	0.2	-0.3	
Structural balance 3/	2.2	-0.7	-1.9	0.5	-0.2	
General government debt	38.3	35.9	32.7	33.2	32.5	
Money and Credit (end-year, percent change)						
M3 4/	14.7	17.2	9.3	9.6	8.3	6/
Private sector credit 5/	21.3	15.1	15.0	17.9	24.8	6/
Interest rates (year average)						
Three-month	4.8	3.3	2.9	2.1	2.1	7/
10-year government bond yield	5.1	5.1	4.3	4.3	4.2	7/
Balance of Payments (percent of GDP)						
Trade balance (goods and services)	13.2	15.0	16.6	15.4	15.3	
Current account	-0.4	-0.7	-1.3	-1.4	-1.6	
Reserves (gold valued at SDR 35 per ounce end of period, in billions of SDRs)	4.1	4.5	4.0	2.8	1.6	6/
Exchange Rate						
Exchange rate regime		Member of euro area				
Present rate (August 12, 2004)		US$ per euro 1.2256				
Nominal effective rate (1995=100)	88.3	89.2	90.7	96.7	96.7	6/
Real effective rate (1996=100, CPI based)	91.0	94.4	98.9	106.8	106.5	6/

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

1/ Staff projections, except where noted.

2/ In percent of GDP.

3/ In percent of potential GDP.

4/ The methodology for calculation of Ireland's contribution to the Euro area money supply was amended in January 2000.

5/ Adjusted change, which includes the effects of transactions between credit institutions and non-bank international financial companies and valuation effects arising from exchange rate movements.

6/ As of June 2004.

7/ As of July 2004.