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Post-Programme Surveillance Report

Ireland, Spring 2016

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EUROPEAN ECONOMY

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European Commission
Directorate-General for Economic and Financial Affairs

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The report reflects information available as of 1 August 2016.

ABBREVIATIONS

ABF Activity-based funding

ABS Asset-backed securities

ABS Asset-backed securities

AIB Allied Irish Bank

APP Asset Purchasing Programme

BEPS Base Erosion and Profit Shifting

BOI Bank of Ireland

BRRD Bank Recovery and Resolution Directive

BTL Buy-to-let

CBI Central Bank of Ireland

CCCTB Common Consolidated Corporate Tax Base

CCMA Code of Conduct on Mortgage Arrears

CCR Centralized Credit Register

CET1 Common equity tier 1

CIT Corporate income tax

CoCos Contingent convertible notes

CPSS Commercial property statistical system

CRD Capital Requirement Directive

CRE Commercial real estate

CRO Credit Review Office

CRR Capital Requirements Regulation

CSO Central Statistics Office Ireland

CSR Country specific recommendation

CTA Common Travel Area

DHPCLG Department of Housing, Planning, Community and Local Government

DoF Department of Finance

DSA Debt Sustainability Analysis

DTA Deferred tax asset

EAPP Extended Asset Purchase Programme

EBA European Banking Authority

ECB European Central Bank

ECJ European Court of Justice

EDP Excessive deficit procedure

EFC Economic and Financial Committee

EFSF European Financial Stability Facility

EFSM European Financial Stabilisation Mechanism

ESM European Stability Mechanism

ESRI Economic and Social Research Institute

ETB Education and training boards

FET Further education and training

HICP Harmonised Index of Consumer Prices

HSE Health Service Executive

IBRC Irish Bank Resolution Corporation

IDA Industrial Development Agency

IDR In-depth review

IFAC Irish Fiscal Advisory Council

IFRS International Financial Reporting Standards

IFSC International Financial Services Centre

IMF International Monetary Fund

INN International non-proprietary name

IPHA Irish Pharmaceutical Healthcare Association

ISI	Insolvency Service of Ireland
ISIF	Ireland Strategic Investment Fund
LDR	Loan-to-deposit ratio
MABS	Money Advice and Budgeting Service
MART	Mortgage Arrears Restructuring Targets
MIP	Macroeconomic imbalance procedure
MTO	Medium-term objective
NAMA	National Asset Management Agency
NPLs	Non-performing loans
NTMA	National Treasury Management Agency
PCRS	Primary Care Reimbursement Service
PDH	Primary dwelling home
PIP	Personal insolvency practitioner
PPM	Post-programme monitoring
PPS	Post-programme surveillance
PPSN	Personal public service number
PRSI	Pay-related social insurance
PTSB	Permanent TSB
q-o-q	quarter-on-quarter
RWA	Risk-weighted assets
SBCI	Strategic Banking Corporation of Ireland
SES	Summer Economic Statement
SGP	Stability and Growth Pact
SME	Small and medium enterprises
SPU	Stability Programme Update
SPV	Special Purpose Vehicle
SREP	Supervisory Review and Evaluation Process
SRM	Single Resolution Mechanism
SSM	Single Supervisory Mechanism
TSG	Tax Strategy Group
UHI	Universal health insurance
USC	Universal Social Charge
VAT	Value added tax
WFD	Water Framework Directive
y-o-y	year-on-year

EXECUTIVE SUMMARY

Ireland's economic adjustment has been remarkable and the challenge for the future will be to achieve continued balanced growth in the face of emerging risks. Ireland's economic recovery has been stronger than expected, providing tailwinds for policy efforts aimed at financial sector repair and the restoration of sustainable public finances. Although some legacy issues remain, especially concerning the financial sector which still has a large stock of non-performing loans and low yielding tracker mortgages, significant progress has been made along many dimensions, including a restoration of sustainable public finances. Yet, as the recovery continues, the authorities must now balance demands for spending increases and tax cuts against the need to complete economic adjustment, increase public investment to address housing and infrastructure bottlenecks and prepare for adverse scenarios. This takes place against considerable uncertainty, regarding both actual and future economic growth, and the future relationship between the UK and the EU. The high degree of domestic and external uncertainty puts an even greater premium on the prudent management of economic policy and public finances. Priority should be given to economic policies that strengthen instruments and frameworks that mitigate the risk of boom-bust cycles and channel the available fiscal space towards debt reduction and public investment, so as to increase the resilience of the economy to shocks and raise its long-term productive capacity.

The Irish economy continued to grow very rapidly in 2015, although the activities of multinationals have made it more difficult to ascertain the composition of underlying growth. An on-shoring of intellectual property combined with an increase in contract manufacturing explains most of the exceptionally rapid growth of real GDP (26.3%) and net exports (102.8%) observed in 2015. Most of this growth in GDP and net exports was previously unaccounted for in quarterly estimates (Box 2). While both of these elements had little impact on actual economic activity, thereby making the interpretation of GDP figures very complex, underlying activity indicators were very positive, supported by broad-based domestic demand. Private consumption grew by 4.8% year-on-year (y-o-y) in Q1-2016, and employment and wages continued to rise — amid very low consumer price inflation (0.1% y-o-y in June) and the release of pent-up demand for durable goods. Unemployment continued to decline and reached 7.8% in May.

The result of the UK referendum on EU membership represents an adverse external shock, but real GDP in Ireland is still expected to grow at robust rates this year and next. The impact of the vote is expected to marginally reduce GDP in 2016 due to the depreciation of sterling, which should result in lower Irish exports to the UK. Consumer confidence may also decline due to increased uncertainty. However, the full effects of the UK 'leave' vote will only emerge over time and will mainly depend on the outcome of the UK-EU negotiations. This creates economic uncertainty for all Member States, but particularly for Ireland.

Following a period of responsible fiscal management, Ireland successfully corrected its excessive deficit in 2015, but further efforts will be necessary to secure fiscal sustainability. Since 2009, when the excessive deficit procedure was launched, the general government balance has steadily improved, with the deficit declining to 1.8% of GDP in 2015 (based on the revised GDP data). Compared to 2014, tax revenues increased substantially in 2015, fuelled by an exceptional and not yet fully understood performance of corporate tax receipts, which grew by around 50%. Budget 2016 included tax cuts and expenditure increases. However, in its assessment (published in May) of the 2016 Stability Programme, the Commission concluded that there is a risk of some deviation from the required adjustment path towards the medium-term objective (MTO) in 2016. Looking to the next budget, according to the government's July Summer Economic Statement, additional spending and tax cuts of around EUR 1 billion in 2017 will be consistent with compliance with the provisions of the Stability and Growth Pact.

The government faces pressure to increase spending and reverse some of the reforms implemented during the programme. These calls for expansionary measures by various political forces and stakeholders would most likely have a negative impact on public finances, as it cannot be assumed that revenue outperformance will continue and discretionary changes to expenditure ceilings remain a feature of the Irish Budget process. In addition, plans to cut personal income taxes and the suspension of water

charges would absorb further resources and represent an erosion of reforms introduced under the programme. However, the 2015 surge in corporate tax revenues was due to developments in global value chains, which benefited Ireland but could reverse equally rapidly. Scope remains to broaden the tax base by switching to more sustainable and growth-friendly sources of revenue. The proposed establishment of a *rainy-day-fund* could provide a useful tool for prudent counter-cyclical fiscal policy.

Private sector deleveraging has continued, including on the back of high nominal GDP growth. Net private credit growth remains depressed though new lending is picking up. Although interest rates on loans have declined somewhat, average Irish interest rates remain above the euro area average. Although the pricing of loans in Ireland is largely a reflection of legacy issues, a lack of competition in the market and difficulties in accessing collateral, banks are under pressure to further reduce variable rates on mortgage lending. The legislative proposal aiming to enable the Central Bank of Ireland (CBI) to cap mortgage interest rates could have a negative impact on the banks' fragile profitability and potentially discourage new entrants into the market. The share of non-performing loans (NPLs) in the banks has continued to decline but remains among the highest in the EU. This still weighs on the banks' capacity to support the recovery and is another factor contributing to high lending rates. Mortgage arrears are decreasing across different loan categories, but the levels of long-term arrears remain elevated and procedural challenges in accessing collateral persist.

Domestic banks' profitability continues to recover and they maintain sound capital levels. The recovery in profitability is due to improving asset quality, higher net interest margins and lower funding costs, though it has also been bolstered by one-off releases of provisions. EU-wide stress tests recently conducted by the European Banking Authority show that Irish banks’ recovery is fragile and could be severely impacted by a deterioration in the economy. Domestic banks experienced a sharp drop in their share prices following the UK referendum but the event did not raise major liquidity concerns. While banks are continuing to pay back their debt to the State, the recent deterioration in market conditions means that State divestments have been postponed until at least 2017.

Residential property price rises have decelerated after the introduction of macro-prudential rules. While the CBI will publish a review of its mortgage lending rules at the end of November 2016, fundamental changes are unlikely as it has already emphasised that the rules will be retained as a permanent feature of the mortgage market. Housing supply shortages in urban areas persist and private sector rents continue to increase rapidly. Construction of new homes is only increasing gradually and new measures aimed at supporting supply will take time to have an effect. Demand side measures could be counterproductive in the current supply-constrained context and could contribute to further upward pressure on prices. The rapid growth in commercial real estate (CRE) values is receiving close supervisory attention, although it does not appear to be driven by credit from domestic banks at this stage.

Structural reforms are progressing gradually while spending pressures in healthcare persist and its cost-effectiveness remains a challenge. Although the transition to universal health insurance has stalled, the Health Service Executive (HSE) recently reached an agreement with the pharmaceutical industry on the price and supply of medicines that is expected to reduce costs by EUR 700 million over four years. As regards other structural reforms, the proposed increase in the minimum wage is not expected to have a significantly adverse impact on employment. Changes to the structure of Irish Water could be costly and might negatively affect the utility's operations.

Repayment risks for the European Financial Stability Mechanism (EFSM) and European Financial Stability Facility (EFSF) loans remain low over the medium-term. This assumes that the authorities continue to implement prudent fiscal and financial sector policies and structural reforms. Public debt to GDP ratio has fallen, largely due to the surge in nominal GDP, but also due to the proceeds from the sale of state-owned banking assets and the achievement of a primary surplus in 2015. Declining debt servicing costs have also facilitated debt reduction and the ECB's monetary policy measures, including the Asset Purchase Programme (APP), are expected to keep borrowing costs low. Despite this, Ireland’s still high

level of public debt makes government debt projections very sensitive to variations in economic growth and to the expected size of budgetary adjustment. As a result, the sustainability of public debt remains vulnerable to adverse economic shocks in the context of intensified uncertainty. Nevertheless, the sovereign's financing situation is expected to remain reasonably comfortable.

Ireland has made some progress in implementing the 2015 country-specific recommendations (CSRs). Under the Macroeconomic Imbalances Procedure (MIP), Ireland has macroeconomic imbalances requiring specific monitoring and decisive policy action. The execution of the MIP-relevant Council recommendations is monitored through PPS. Overall, the fifth PPS review concludes there have been advances in addressing the relevant CSRs adopted by the Council in 2015.

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1. INTRODUCTION

Staff from the European Commission (EC), in liaison with the European Central Bank (ECB), undertook the fifth PPS review mission for Ireland from 7 to 10 June 2016. The European Stability Mechanism (ESM) participated in the meetings on aspects related to its own Early Warning System ([1]). The Single Supervisory Mechanism (SSM) was also represented with staff from both the ECB and the national competent authority, the Central Bank of Ireland (CBI). Post-programme surveillance (PPS) aims to assess the economic, fiscal and financial conditions with the ultimate goal to monitor the repayment capacity of a country that has received financial assistance ([2]). There is no policy conditionality under PPS, but the Council of the European Union can issue recommendations for corrective actions if necessary. Overall, the results of the fifth PPS review point to very limited risk to the capacity to repay. The next repayment of loans from EU lenders is scheduled in 2018, although the maturity extensions granted in 2013 mean that 2018 EFSM maturities will actually be refinanced ([3]).

The PPS mission includes specific monitoring under the MIP. The results of the in-depth review (IDR) for Ireland carried out under the 2015 European Semester confirmed that remaining macroeconomic imbalances require decisive policy action and the specific monitoring of the implementation of Macroeconomic imbalance procedure (MIP) -tagged Country specific recommendations (CSRs) ([4]). Overall, there have been further advances with addressing CSR 1 on fiscal consolidation and with tackling CSR 4 concerning the restructuring of loans in arrears. A more detailed overview of the progress made with the 2015 MIP-tagged CSRs is provided in Annex 1.

([1]) On this occasion, the mission was not coordinated with Staff from the International Monetary Fund (IMF), who attended a separate set of meetings later in June under their Article IV and FSAP monitoring procedures. It is envisaged that the next PPS mission will once again be coordinated jointly with the IMF.

([2]) PPS is foreseen by Article 14 of the two-pack Regulation (EU) N°472/2013. It starts after the expiry of the EU/IMF financial assistance programme and lasts until a minimum 75% of the financial assistance has been repaid. It may be extended if there are financial difficulties or fiscal instability issues.

([3]) On 21 June 2013 the Council of the European Union adopted Implementing Decision 2013/313/EU to increase the average maturity of EFSM loans to Ireland to by seven years to 19.5 years. Thus, Ireland has the option to request that any maturing tranche under its EFSM loans be extended. This needs to be formally notified four months prior to the relevant expiry date.

([4]) See Communication from the Commission to the European Parliament, the Council and the Eurogroup, 2015 European Semester: Assessment of growth challenges, prevention and correction of macroeconomic imbalances, and results of in-depth reviews under Regulation (EU) No 1176/2011, http://ec.europa.eu/europe2020/pdf/csr2015/cr2015_comm_en.pdf.

2. RECENT ECONOMIC DEVELOPMENTS AND OUTLOOK

2.1. RECENT MACROECONOMIC AND FISCAL DEVELOPMENTS

The Irish economy performed strongly in 2015 and the first quarter of 2016. Initially driven by net exports, the recovery has become more broad-based, extending to domestic demand components across most economic sectors. Private consumption grew by 5.0% y-o-y in Q1-2016, driven by rising employment and wages, very low consumer price inflation and the release of pent-up demand for durable goods. "Core" investment (excluding purchases / imports of intangible assets and aircraft for leasing) fell y-o-y in Q1-2016 after very high growth in the previous quarters ([5]) when companies continued to replenish their capital stock and the country attracted further productive investment from abroad. Government consumption expenditure grew by 3.5% y-o-y in Q1-2016, contributing positively to GDP growth. Real GDP fell in Q1-2016 q-o-q but this fall can be attributed to the volatility of investment components.

Headline GDP figures were strongly affected by the operations of some multinationals. In 2015, a small number of multinational companies imported large volumes of intellectual property assets from non-EU jurisdictions into Ireland. In addition, companies moved operations to Ireland, resulting in the reclassification of entire balance sheets. These activities were probably driven by changes in global value chains and the international tax environment. They caused changes to the composition of GDP growth in Ireland, by directly increasing headline investment and import figures by roughly equivalent amounts, and altered the impact of contract manufacturing on GDP growth ([6]). Following the on-shoring of patents, a larger share of the value added in global production chains is now booked in Ireland, which resulted in a level shift in the volume of GDP in 2015. This explains most of the very rapid growth rates of net exports (102.8%) and GDP (26.3%) in 2015 in real terms (Box 1). These rates normalised in Q1-2016.

Most of the GDP growth in 2015 was previously unaccounted for in quarterly estimates. The first full-year results, published in July 2016, show that GDP growth in 2015 was 18.5 pps. higher than anticipated by quarterly estimates. This very large revision does not reflect any major development on the domestic economy but is due to previously unaccounted operations by multinationals. However, the revision has a direct arithmetic effect on every indicator expressed as a share of GDP, including the debt-to-GDP ratio (Box 1).

Unemployment has declined substantially while employment growth decelerated but remained above the euro area average. The unemployment rate has continued to decline and is now below the euro area average as it reached 7.8% in May and June 2016, compared to 9.4% a year earlier. Employment grew by 2.4% y-o-y in Q1-2016 and its increase was broad-based across sectors. Yet, it decelerated since the last quarter of 2105 in non-seasonally adjusted terms. Also in Q1-2016, the number of long-term unemployed declined by 1,500 q-o-q. Yet, the long-term unemployment rate remained constant at 4.7%, down from 6% a year earlier. The participation rate only increased slightly, by 0.1% y-o-y, while the impact of net outward migration on the labour force continued to decline. Average weekly earnings grew by 1.1% y-o-y and by 0.7% q-o-q in seasonally adjusted basis.

Inflation remains very subdued by historical standards. In June 2016, consumer price inflation grew by 0.1% y-o-y and 0.7% month-on-month (m-o-m) thanks to the progressive recovery in energy prices. Prices for services are growing moderately, including in the hospitality sector and as a result of rising rents.

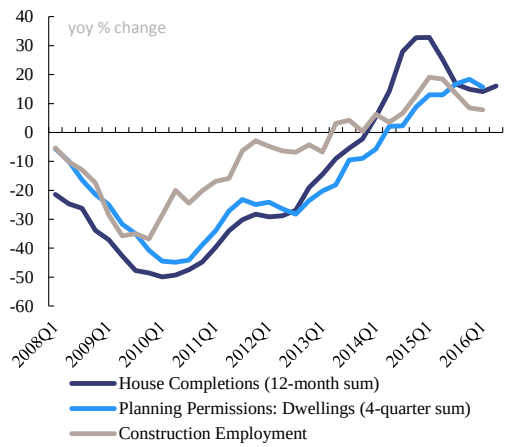
Residential property prices increases have moderated somewhat while commercial real estate prices remain buoyant. Although nationally residential prices increased by 6.6% y-o-y in June 2016, down from 13.8% a year earlier, there was substantial regional variation. While price increases excluding Dublin stood at

([5]) The y-o-y growth rate of core investment was negative in Q1-2016 for the first time since Q1-2013. Estimate based on Commission staff calculations.

([6]) Contract manufacturing refers to a company resident in Ireland contracting the production of goods abroad. Under the European System of Accounts 2010, the sale of those goods is recorded as an export from Ireland irrespective of their physical location. Inputs to the production process are also recorded as imports into Ireland. Previously, exports from contract manufacturing had been almost fully offset by imports (including imports of patent use rights), making this phenomenon roughly neutral to GDP growth.

8.6% y-o-y in June, in Dublin price increases slowed to 4.5% y-o-y. This occurred despite an undersupply of housing in urban areas, particularly Dublin. The CBI has recently stated that the introduction of macro prudential loan-to-value (LTV) and loan-to-income (LTI) rules have almost certainly had an effect on price developments and contributed to a shift in housing demand towards rental accommodation ([7]). Private Rents rose by 9.3% y-o-y in June 2016. Moreover, rents in Dublin are now 0.7% higher than the previous peak in early 2008, while residential property prices in Dublin remain 35.6% lower than at the peak in February 2007. Capital values for commercial office space in Dublin increased 17.1% y-o-y in the first quarter of 2016, while rents increased 17.7% y-o-y in the second quarter of 2016 ([8]). Market participants expect further increases as demand is expected to remain strong while it will take time before new projects are completed.

Graph 2.1: **Residential Property Market Developments**



Source: CSO, Department of Housing, Planning, Community and Local Government

Housing supply still lags demand, as the gradual recovery in construction continues from a low base. Only 12,666 residential housing units were completed in 2015, an increase from 11,016 completed in 2014. These figures remain far below estimated demand of 25,000 units annually. Housing commencements remained relatively low at 8,088 in 2015. There are signs of recovery, however, the volume of production in building and construction increased by 8.3% in 2015, including a rise in residential building production of 26.5%, a recovery from historically low levels. Forward-looking indicators suggest an acceleration in construction output with the Department of Housing, Planning, Community and Local Government (DHPCLG) reporting an increase in house completions up 16% y-o-y in June 2016, while the Ulster Bank construction sector PMI has been consistently pointed to an expansion of output, standing at 59.7 in June 2016.

Ireland corrected its excessive deficit in 2015, marking a key step towards ensuring fiscal sustainability. According to the most recent data, the general government deficit fell to 1.8% of GDP in 2015, down from 3.7% a year earlier ([9]). Since 2009, when the underlying ([10]) deficit peaked at around 11.5% of GDP, the general government balance has steadily improved. Overall, the deficit reduction was mainly driven by expenditure restraint, with the share of current primary expenditure in GDP declining by 13.2 pps. over 2010-2015, while the revenue-to-GDP ratio declined by 5.5 pps. during the same period ([11]).

([7]) See address to Financial Stability Department in the Sveriges Riksbank, by Lars Frisell, Advisor to the Governor, http://www.centralbank.ie.

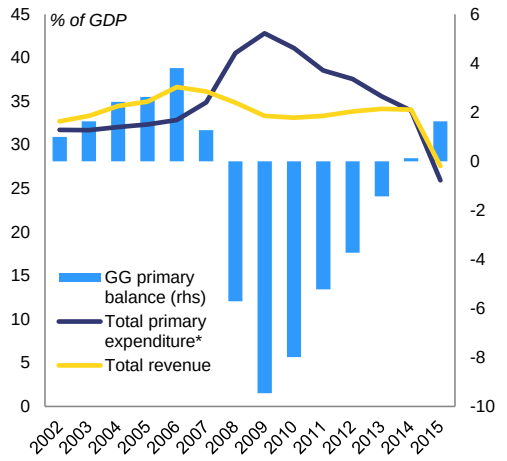
([8]) See Jones, Lang Lasalle Property Index, Q1 2016 http://www.jll.ie/ireland/enie/Research/JLL%20Irish%20Property%20Index%20-%20Q1%202016.pdf and CBRE Dublin Office Market Review, Q2 2016 http://researchgateway.cbre.com/Layouts/GKCSearch/DownLoadPublicUrl.ashx

([9]) CSO released the Government Income and Expenditure 2015 results on the 13 July, which also take into account the latest revisions to GDP. The April 2016 EDP notification had assumed a deficit of 2.3% of GDP in 2015. The deficit in 2015 would drop by 1.0% of GDP once a one-off transaction, related to the restructuring of Allied Irish Banks' (AIB) capital base, is excluded.

([10]) Excluding deficit-increasing one-off measures related to financial sector support

([11]) While ratios could be somewhat distorted by the substantial increase in GDP in 2015, figures in absolute terms are still revealing with current primary expenditure remaining relatively flat (+1.3%) and total revenues increasing by 27% over 2010-2015, while GDP grew cumulatively by 53% over the same period.

Graph 2.2: **Fiscal developments and composition**

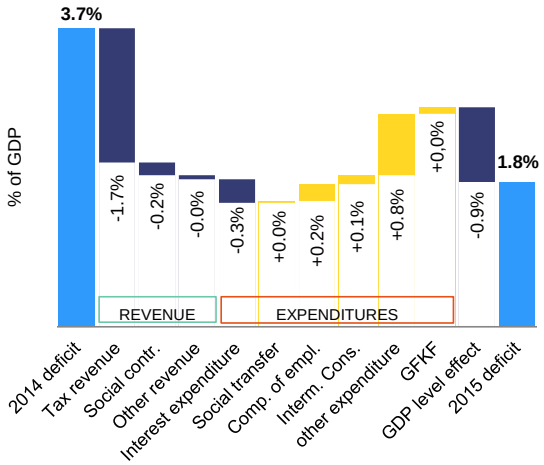


(1) Total primary expenditures are net of one-offs to take into account costs related to bank-rescue operations.
Source: European Commission

Favourable cyclical developments have underpinned fiscal adjustment in recent years. According to the Commission spring forecast ([12]), the structural budget balance improved by around 5 pps of GDP in the period 2010-2013 whilst improving by around 2 pps. of GDP in 2013-2015. In particular, in 2015 the cyclical component of the adjustment was larger than the structural one, at 2.0% of GDP versus 0.5% of GDP respectively ([13]) (Graph 2.3).

The improvement in the 2015 deficit reflects strong government revenues and a substantial increase in GDP. Compared to 2014, tax revenues ([14]) increased by 9.2% in 2015, fuelled by the exceptional performance of corporate tax receipts, which grew by around 50%, as the substantive relocation to Ireland of intellectual property assets led to a strong increase in the gross operating surplus. There were spending increases in the public wage bill (2.9% y-o-y) and in the consumption of goods and services (3.2% y-o-y) but, overall, current expenditure flattened (-0.3% y-o-y). Gross fixed capital expenditure increased by 4.2% compared to the previous year, but this is still far below (-16%) the 2000-2005 average level (around EUR 5.2 billion). Moreover, the ratio of current to gross fixed capital spending almost doubled from the 2000-2005 average (from 7:1 to 14:1 in 2015). Due to relatively low market interest rates, as well as the early repayment of IMF debt, debt interest costs fell by about 10%. The mechanical effect of GDP growth on the deficit-to-GDP ratio amounts to about 0.9% of GDP (Graph 2.3)

Graph 2.3: **2015 public deficit improvement**



(1) Data reflect the latest CSO government finance statistical release, which also take into account revision to GDP.
Source: European Commission

Public finances continue to largely outperform budget projections through end-June 2016. Tax revenues in the first half of the year grew by 9.2% compared with the same period of 2015 and were EUR 742 million higher compared to budget projections. Unanticipated corporation tax receipts (EUR 505 million) and larger-than-expected excise duties (EUR 401 million) were behind revenue over performance, while VAT receipts were EUR 231 million below expectation. End of June data also showed an overall spending discipline outside continued overruns in the health area (EUR 138 million) ([15]). Through end June, the exchequer cash deficit ([16]) was EUR 2 billion

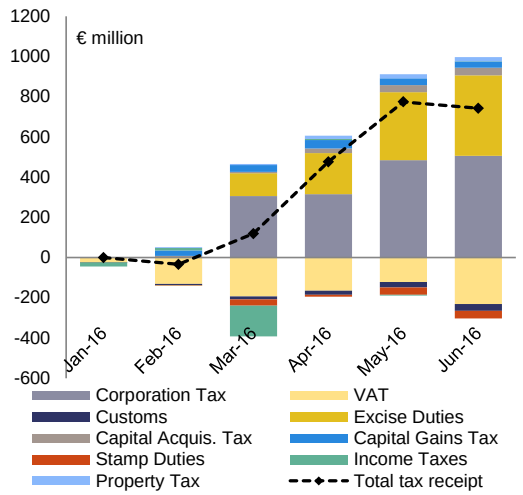
([12]) The Commission spring forecast was released prior to the CSO's release of the Government Income and Expenditure 2015 results on the 13 July.
([13]) According to the April 2016 EDP notification, nominal deficit, net of one-offs, improved by 2.5 pps. of GDP in 2015, while, in structural terms, it improved by 0.5 pp. of GDP.
([14]) Tax revenues are calculated as the sum of indirect, direct and capital taxes (D2, D5 and D91 in ESA2010 terms).

([15]) In June the government allocated an extra EUR 500 million to Health in 2016 to address emerging overruns.
([16]) Excluding transactions not impacting the general government balance

(0.8% of GDP), 40% lower than planned in the budget.

Yet, revenue outperformance may not be durable. While recent revision of national account data may help to explain some of the upsurge in corporate tax receipts ([17]), this source of revenue remains volatile, subject to abrupt decisions by a small number of large MNEs and likely polluted by uneven payments. Similarly, excise duty strong performance reflects likely temporary behaviours, such as a strong increase in car sales and tobacco receipts. The latter is due to a front loading of purchases, in advance of the implementation of a plain packaging initiative, which is expected to unwind in the second half of the year. Strong revenue swings must therefore be treated with caution when setting fiscal policy.

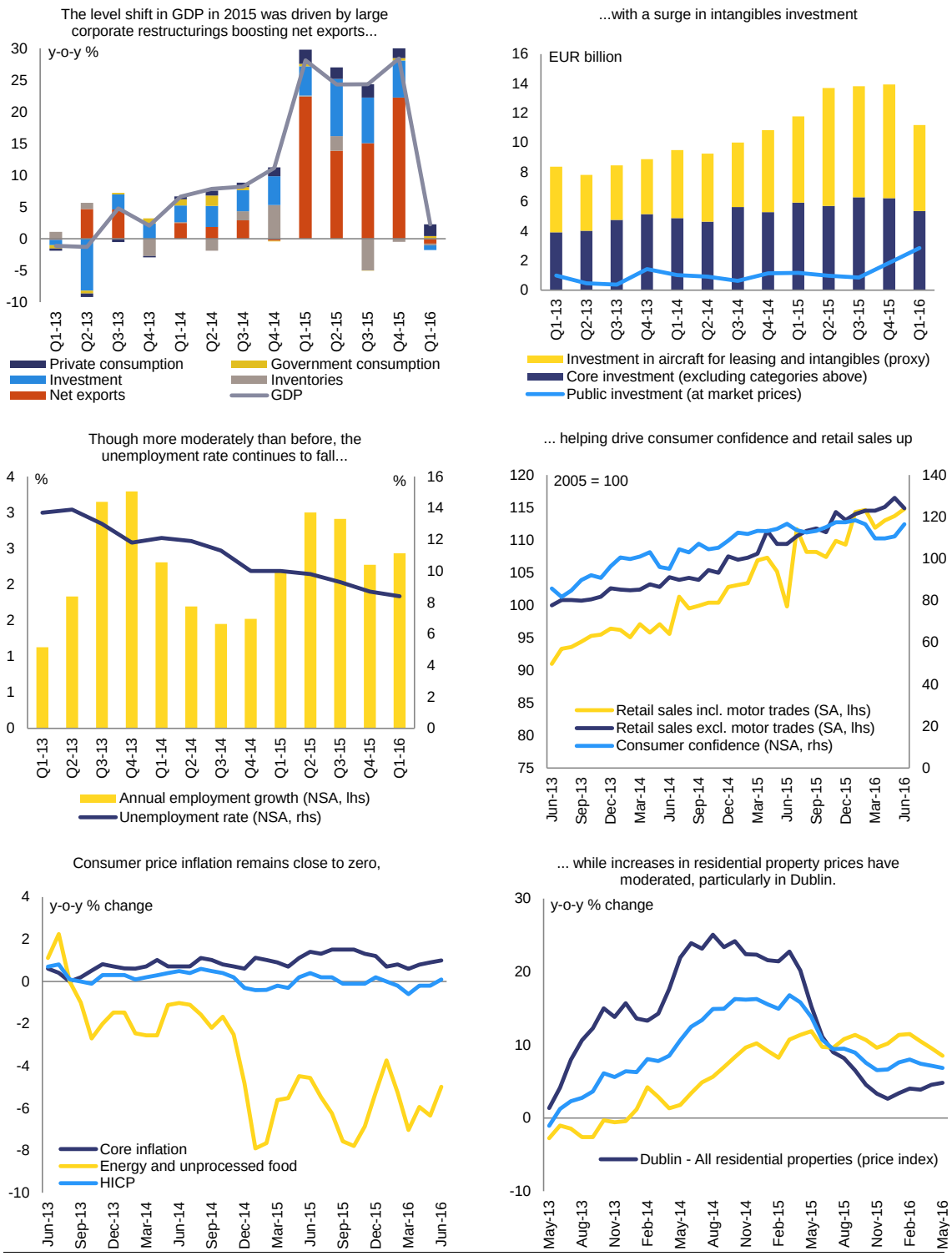
Graph 2.4: **End-June cash returns: outturn vs Budget projection**



Source: Department of Finance (Ireland)

([17]) The data now show a better alignment between gross operating surplus (+44%) and corporate tax receipts (+49%) changes in 2015.

Graph 2.5: **Recent economic developments**



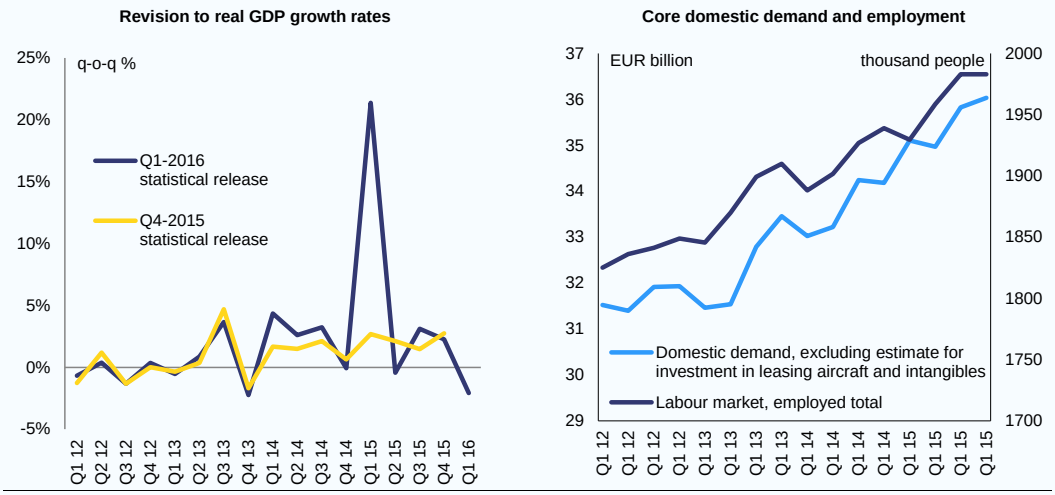
Source: European Commission, Central Statistics Office

Box 2.1: Irish GDP growth in 2015

The inclusion of new information has led to a very substantial revision of the initial estimates of economic growth in 2015. On 12 July, the Central Statistics Office (CSO) released the National Income and Expenditure Annual Results 2015. This first full-year results show that GDP grew by 26.3% in 2015, that is, 18.5 pps. higher than anticipated in March 2016, when quarterly estimates pointed to an annual GDP growth rate of 7.8% (Graph 1). The results were compiled in accordance with the latest EU statistical framework, ESA 2010, implemented in autumn 2014. The full-year results are based on new information, including corporate tax data and structural statistics, which were not available in March. Eurostat carried out the usual process of data validation and published the updated aggregates for Ireland on Eurobase on 21 July.

The revisions are primarily explained by large-scale corporate restructurings. In the course of 2015, a small number of multinational companies transferred large volumes of intellectual property assets (patents) into Ireland. In addition to these imports of individual assets, companies moved operations to Ireland, resulting in the reclassification of entire balance sheets. These assets and operations originated in non-EU jurisdictions so their transfers had no impact on the national accounts of other EU Member States. Recent changes to the international tax environment may have played a role, with corporate strategies anticipating the OECD/G20 Base Erosion and Profit Shifting (BEPS) package. Ireland's competitive company taxation and business environment, coupled with many companies' existing presence in the country, make the jurisdiction attractive for onshoring assets. The details of the transactions are not public due to statistical confidentiality. Eurostat has warned that similar phenomena could happen in the future, even within the EU.

Graph 1: **Statistical revisions and underlying domestic demand dynamics**



Source: European Commission

This large level shift in GDP had little impact on the domestic economy and employment but may explain part of the substantial increase in corporate tax revenue. In practical terms, these corporate restructurings mean that the companies involved start to book a larger share of value added and profits in Ireland. As a result, net exports of goods and services more than doubled in 2015, including on account of reduced imports of patent use rights. The annual corporate tax intake increased by 49% compared to 2014, due to the increase in profits from multinationals (although the link with the 2015 corporate restructurings is uncertain) and the domestic recovery. However, the impact on employment has not been very significant, since most of the activities affected are either very capital-intensive or based on contract manufacturing (the production of goods outside of Ireland on behalf of Irish-domiciled entities). Yet, employment grew by 2.6% in 2015, highlighting the strength of the domestic recovery (Graph 1). At the same time, this level shift will have an impact on any indicator presented as a ratio to GDP, including the debt-to-GDP ratio.

(Continued on the next page)

Box (continued)

The CSO announced that it intends to complement the publication of GDP and GNP aggregates with a broader set of indicators. Following the publication of the 2015 full-year results, the CSO issued a statement concluding that GDP and GNP no longer provide sufficient information on the evolution of the domestic side of the Irish economy. This is due to the small size, openness and very high degree of globalisation of the Irish economy, which continues to challenge the compilation of macro-economic statistics in an Irish context. A broad expert group has been set up to consider which additional set of indicators could be published alongside GDP and GNP figures to help expert users and the public gain a better understanding. A report with the conclusions of this work is expected before the end of the year.

Box 2.2: Implications of the UK's negative vote on EU membership for Ireland

The immediate consequences of the UK 'leave' vote on the Irish economy are expected to be limited. Real GDP in Ireland is still expected to grow at robust rates this year and next despite the adverse shock following the result of the UK referendum (Section 2). In the aftermath of the referendum, while stock market losses in Ireland were somewhat above European averages, sovereign bonds remained rather stable (Graph 1). The latter market reaction was indicative of continued investor confidence in Ireland, reflecting the strengths of its economic model and the good track record in the adjustment process that followed the burst of the domestic real state bubble and global financial crisis. The dependence of the Irish economy on the UK has declined dramatically since Ireland joined the European Union, but remains significant ([1]).

Following extensive contingency planning, the Irish government released its priorities to address short-term and medium-term risks. The government set up an interdepartmental group in early 2015 to identify the spillover channels of a UK exit for Ireland. Immediately after the referendum, it made some of those contingency plans public. These are based both on Ireland's full commitment to the EU and its preference for continued close EU-UK cooperation, not least because Ireland's interdependence with the UK is greater than that of any other EU Member State. The plan puts forward priorities in the following areas:

- **Economy** — ***The government will review its Summer Economic Statement***, which envisaged a EUR 1 billion fiscal expansion in 2017. A UK 'leave' vote was the most significant risk highlighted in the Statement. The Draft Budgetary Plan, to be presented in the autumn, will be based on a new macro-economic scenario. At present, the government has indicated that it expects GDP growth to be 0.5 pps. lower in 2017 than presented in the Statement.
- **Trade** — ***The government plans to take measures to assist Irish exporters***, to help them to maintain their UK market shares and diversify to other markets. The share of the UK in Ireland's goods and services exports (14% and 20% respectively) has declined substantially since 1973 when the UK accounted for approximately half of total Irish exports. As a result, the rest of the EU combined is now a larger trade partner for Ireland. However, the UK remains by far the most important export destination for some domestic firms, particularly in labour-intensive sectors such as the agri-food business and traditional manufacturing.
- **Northern Ireland** — ***The government will seek to preserve political and social stability and minimise the negative economic impact on the border region***, which are particularly vulnerable to the imposition of trade barriers. The future of the funding that regions on both sides of the border receive from EU programmes such as the Programme for Peace and Reconciliation funds will also need to be clarified.
- **Common Travel Area (CTA)** — ***The government will seek to preserve the UK-Ireland CTA and to minimise impediments to cross-border movements of goods, people and services***. The future of the CTA is of great concern to the Irish government, given the economic, social and political implications. Approximately 400,000 Irish citizens are estimated to live in the UK while there are over 110,000 UK nationals living in Ireland ([2]). These figures are significant from an Irish labour market perspective.
- **Energy** — ***The government will seek to preserve the existing extensive interconnection arrangements, while the issue of the single electricity market with the UK will be a priority issues for negotiation***. A study from the Institute for International European Affairs argued that the UK exiting the EU would have an uncertain effect on electricity prices in Ireland but emphasised the potential for negative consequences in terms of energy security.
- **Foreign investment** — ***The government is working to reassure foreign investors of its commitment to the EU and to attract any newly-mobile FDI***. Some of the very large stock of inward FDI located in the

([1]) As a rule of thumb, a -1% contraction in UK GDP leads to a -0.3 contraction in the Irish economy, without considering second round effects.

([2]) Central Statistics Office, Census 2011, Profile 6: Migration and Diversity. http://www.cso.ie/en/newsandevents/pressreleases/2012pressreleases/pressreleasecensus2011profile6migrationanddiversity/

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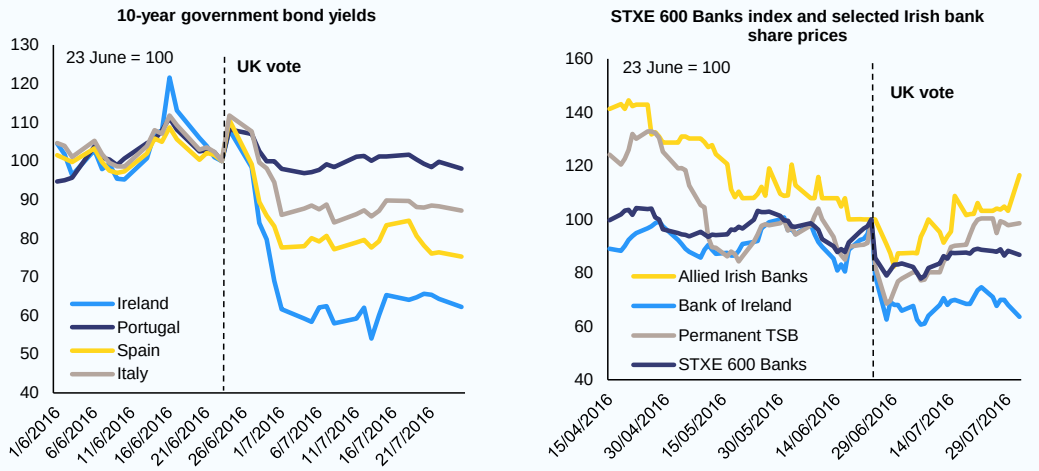
Box (continued)

UK may be sensitive to the terms of the UK exit. The relocation of some activities to Ireland is likely and could have a noticeable positive impact on the Irish economy, given its relatively small size. Ireland is already an established location for some sectors and could attract others with a preference for an English-speaking country, a friendly business environment and a flexible labour market.

However, there is also the potential for greater tax competition from the UK. In the aftermath of the referendum, former Chancellor Osborne announced his intention to reduce the UK's corporation tax rate to 15%, close to Ireland's 12.5%. This could represent a threat to Ireland's economic model, oriented towards FDI, depending on the terms of access for UK goods and services into the EU single market after the UK exits the EU.

Graph 1: **Government bond yields and share prices in the aftermath of the referendum**



Source: Bloomberg, Data Insight, European Commission

As regards the financial sector, banks' share prices experienced sharp drops immediately after the UK 'leave' vote, but did not raise major liquidity concerns. The five main retail banks in Ireland have about 21% of their total assets in the UK and have significant exposure to UK real estate. In addition, Ulster bank's parent bank, Royal Bank of Scotland (RBS), is partly owned by the UK Treasury. The heightened market uncertainty following the referendum weighed on the domestic banks' market valuations. This was especially true for Bank of Ireland (BOI) whose shares fell by over 30% in the post referendum week, on account of its large UK business. Allied Irish Banks (AIB) lost about 17% while Permanent TSB's (PTSB) shares fell by about 25% in the week after the referendum ([3]). PTSB is still undergoing restructuring and only returned to profitability recently (it recorded profits in the first half of 2016). Even though the overall exposure of Irish banks to UK commercial real estate (CRE) is modest, PTSB continues to monitor the market with a view to selling their remaining Capital Home Loans (CHL) portfolio comprised of UK buy-to-let property assets, as the sale is a mandatory requirement in its restructuring plan ([4]).

The full impact of the UK referendum result on the domestic banks will only be seen in the medium term. Domestic banks could suffer from a general economic deterioration affecting their UK customer base. The result of the referendum could also have an impact domestically, particularly through the deterioration

([3]) It should be noted that the trading volume in both banks' stocks is limited as the State retains a significant ownership stake in PTSB and essentially remains the sole owner of AIB.
([4]) As per PTSB's restructuring plan, the sale of CHL is only mandatory if the offer price is above 90% of the gross value of loans.

(Continued on the next page)

Box (continued)

of business prospects for Irish companies exposed to the UK and affected by the depreciation of sterling. More broadly, the fragile profitability and the low interest-rate environment are expected to continue to be a challenge for the banks. Domestic supervisors are monitoring the situation closely.

Regarding upside risks, there is potential for a relocation of financial services firms from London to Dublin. The International Financial Services Centre (IFSC) in Dublin currently hosts multinational financial firms, many of which provide back-office activities for desks located in London. However, Dublin will face competition from other cities with a strong financial sector such as Paris or Frankfurt. In addition, any potential location will find it difficult to quickly replicate London's agglomeration advantages ([5]). In the case of Dublin, the availability of real estate, in particular housing, currently represents an additional limiting factor. Thus, the scale of financial sector relocations to Ireland is uncertain and would probably arrive only gradually. Lower inward financial FDI in the UK could also have a negative impact on the UK economy and, therefore, on foreign demand for Irish products. Ultimately, the continued location of financial services firms in the UK will depend on their ability to access the EU single market ("passporting") once the UK exits the EU.

([5]) Global Counsel (2015) BREXIT: The impact on the UK and the EU. https://www.global-counsel.co.uk/sites/default/files/special-reports/downloads/Global%20Counsel_Impact_of_Brexit.pdf

2.2. RECENT FINANCIAL SECTOR DEVELOPMENTS

The economic rebound has helped domestic banks to improve their pre-provision profitability, but several factors could cloud further progress. Bank profitability continues to recover with improving asset quality, higher net interest margins and lower funding costs, though it has also been bolstered by one-off provision write-backs. The stock of low-yielding tracker mortgages is running off steadily at a rate of roughly EUR 4 billion per year: in March 2016 there were EUR 54.4 billion of trackers outstanding, compared with EUR 58.8 billion one year prior and EUR 63.9 billion two years prior ([18]). Although confident that there is still scope for further widening of net interest margins, the banks are also focussing on increasing the new lending volumes. In fact, there have been signs of a moderate pickup in new lending, but as yet more debt is repaid the net lending remains negative, and banks' balance sheets keep shrinking. Looking forward, it could be challenging for banks to further improve profitability in an environment of prolonged low interest rates, especially if firms and households continue to deleverage.

([18]) From a high of EUR 72.8 billion at the end of 2010. Tracker mortgage balances have been declining faster than non-trackers, and faster than total mortgages outstanding. Interest rates on tracker mortgages follow movements in official policy rates.

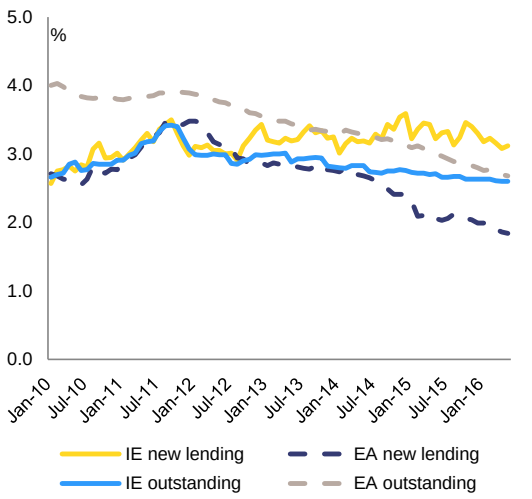
EU-wide stress tests conducted by the European Banking Authority (EBA) ([19]) show that the Irish banks' recovery is fragile and could be severely impacted by a reversal in the macroeconomic environment. Allied Irish Banks's (AIB) and Bank of Ireland's (BOI) stressed capital ratios were lower than those of most of their peers in Europe with a fully-loaded common equity tier 1 (CET1) ratio of 4.3% and 6.1% respectively, compared to a European average of 9.2%. The results are partly a reflection of (i) the still high existing stock of non-performing loans and deferred tax assets (DTAs) of the two banks; (ii) a particularly severe GDP shock assumption in the adverse scenario ([20]); and, to a lesser extent, (iii) the static balance sheet approach applied in the exercise, which assumed the replacement of the costly contingent convertible notes (CoCos) with similar instruments. The results will inform the Supervisory Review and Evaluation Process (SREP) of the Single Supervisory Mechanism (SSM).

([19]) European Banking Authority stress test results: http://storage.eba.europa.eu/documents/10180/1532819/2016-EU-wide-stress-test-Results.pdf

([20]) The participating Irish banks' provisioning losses during the adverse stress were significantly impacted by starting point NPLs. The latter, albeit in decline for years now, remain elevated. As regards GDP projections, Estonia, Greece, Latvia and Slovakia are the only euro area member states for which a sharper GDP drop from the baseline was assumed under the adverse scenario in 2018. The cumulative euro area drop was 6.8% (in comparison with Ireland's 10.4%).

The private sector continues to deleverage though new lending has picked up. In May 2016, net credit to households declined by 3.4% y-o-y while corporate credit declined by 6.3% y-o-y. On the other hand, domestic banks' new lending was up 15% q-o-q and 38% y-o-y as of December 2015, most of it being SME/corporate loans and mortgages. Albeit still high in euro-area terms, the cost of borrowing for households has declined, with the average interest rate on a new floating rate mortgage falling by 49 basis points over the year to 3.6% at end-March 2016 (Graph 2.6). The interest rate on SME loans ([21]) is likewise higher than the euro-area average but declined by 29 basis points over the last year to 4.9% in March 2016.

Graph 2.6: **Mortgage interest rates, new lending**



(1) The Irish interest rates series excludes buy-to-let properties.
Source: European Central Bank

The domestic banks maintain sound capital levels, and they continue to pay back their debt to the State. The domestic banks meet the regulatory capital requirements, with an average fully-loaded CET 1 ratio of 14.3% at the end of March 2016. AIB repaid EUR 1.7 billion in December 2015 and a further EUR 1.8 billion of CoCos in July 2016 ([22]). Bank of Ireland redeemed EUR 1.3 billion of its 2009 preference shares and EUR 1 billion of CoCos in July 2016 ([23]). The domestic banks now maintain a healthier funding mix by relying more on deposits while reducing their dependency on interbank loans and central bank funding. The amount of low-yielding National Asset Management Agency (NAMA) bonds held by banks is also decreasing, as are deferred tax assets (DTAs) ([24]). The yields on Irish banks' debt increased amid market turmoil and are still relatively high when compared to the banks' peers in the euro-area.

The non-performing loan (NPL) ratio continued to decline as a result of economic growth and ongoing restructuring efforts. The NPL ratio for the domestic banks fell to 15.4% at the end of March 2016, down from 16.1% at the end of 2015, and a peak of 27.1% at the end of 2013. The coverage ratio (provisions/NPLs) remained stable at about 52% at the end of the first quarter of 2016, with the supervisor encouraging prudent asset valuations and warning against premature provision releases.

Arrears continued to decline noticeably across different loan categories, but levels of long-term arrears remain elevated. At end-March 2016, 14.3% (about EUR 18 billion) of the total mortgage balance was in arrears (at least 90 days past due). This value is down from 14.7% at end-2015 and a high of 19.9% in the third quarter of 2013. Almost 70% of the non-performing mortgage balance is past due for more than two years and these cases are often particularly hard to restructure. Although many of these cases are currently the subject of legal proceedings ([25]), the number of repossessions remains low ([26]),

([21]) This excludes financial intermediation and property related sectors.
([22]) AIB's capital stock reorganisation lead to an increase in the fully loaded CET 1 ratio, from 9.2% at end-September 2015 to 13% at end of 2015 and 13.3% end-March 2016.
([23]) It should be noted that the BOI transactions involved returns to private investors and were not payments to the sovereign as the State sold its interest in the preference shares and CoCos in 2013. BOI's fully loaded CET 1 ratio was an estimated 10.7% as of end-June 2016, a decrease from 11.3% in end-December 2015. The decrease is primarily due to the fully loaded impact of an increase in the pension deficit. The 2009 Preference Stock was derecognised from CET 1 regulatory capital in November 2015.
([24]) The amount of DTAs held by domestic banks at end-2015 was still a substantial EUR 4.4 billion. Their reduction has a diminishing effect on the banks' fully loaded capital CRR/CRD IV ratios.
([25]) An estimated 22% of all covered banks' (proposed or concluded) mortgage resolution agreements are geared towards a repossession proceeding.
([26]) 723 properties were repossessed, either on the basis of a court order or voluntarily, during the first quarter of 2016.

indicating persisting procedural challenges in accessing collateral. There are still pockets of loans in negative equity, particularly those that were originated at the peak of the house-price cycle. The business and SME portfolio, which makes up one fifth of the domestic banks' loan books, had an NPL ratio of 12.7% as of March 2016, while 35.9% of investment property loans were in arrears.

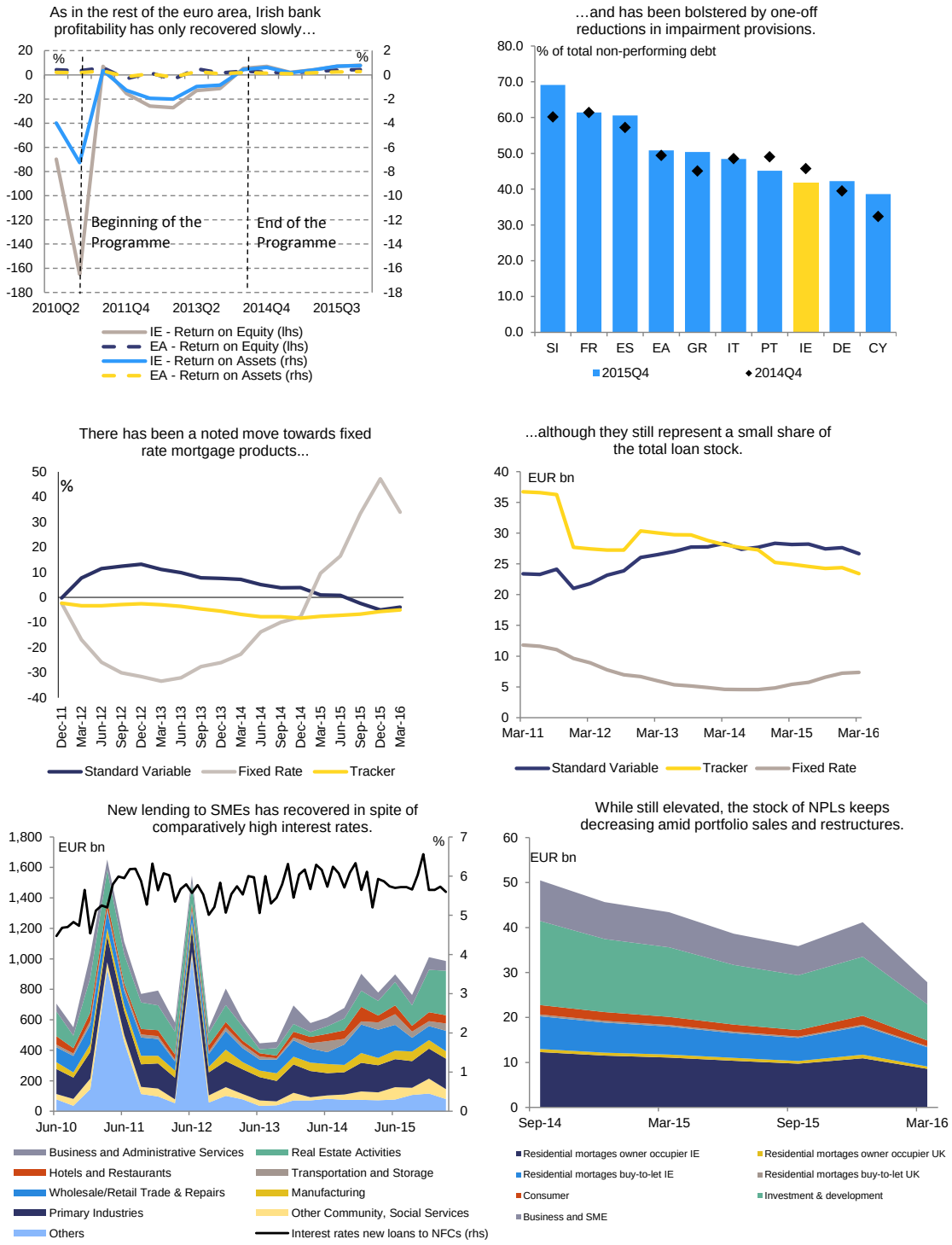
The National Asset Management Agency (NAMA) looks set to achieving its sales and debt redemption targets. As of June 2016, it had generated EUR 35.2 billion from the sale of commercial real estate loans/property and debtors refinancing their debt, and it is expected to achieve a surplus of around EUR 2 billion by the time it winds-down. It has redeemed EUR 25.6 billion or 85% of the EUR 30.2 billion of its senior debt, which bodes well for its aim of achieving full repayment by 2018.

The authorities indicated that unfavourable market developments ([27]) could push back the planned sale of their 25% stake in AIB. This had tentatively been scheduled for the first half of 2017. Proceeds from the sale of holdings in the banks will be used to repay general government debt.

Although this represents an increase compared to the previous quarter (539 repossessions), it is modest when compared to 50,716 accounts in arrears for over two years at the end of March 2016.

([27]) These include a lack of investor appetite due to low returns in the broader banking sector as well as uncertainties deriving from the UK ‘leave’ vote.

Graph 2.7: **Recent financial sector developments**



(1) Graph 1: Domestic banking groups and stand-alone banks; programme is the EU/IMF financial assistance programme for Ireland.
(2) Graph 5: The EA interest rate is retrieved from the ECB SDW and refers to all mortgages. NFCs: non-financial corporations.

Source: Bloomberg, Central Bank of Ireland, European Central Bank

2.3. OUTLOOK

Real GDP in Ireland is expected to grow at robust rates this year and next. Economic growth is forecast to be broadly resilient to the uncertainty springing from the UK 'leave' vote as the dependence of the Irish economy on the UK, though significant, has come down dramatically since Ireland joined the European Union. As a result, a slowdown in the UK economy would affect economic activity in Ireland only half as much as an equivalent shock to the rest of the EU ([28]). However, world trade indicators, industrial production and customs data point to a deceleration in exports. The level shift in GDP experienced in 2015, as a result of the trans-national reorganisation of some multinationals, is not expected to be reproduced in 2016 and 2017.

Private consumption and investment are forecast to contribute positively to growth. Recent gains in employment and labour income are expected to continue to support household consumption in spite of the likely hit to consumer confidence linked to uncertainty. Investment is expected to continue growing at healthy rates, as Ireland will remain an attractive location for firms seeking an entry point into EU markets. Regardless of the outcome of the EU-UK negotiations, Ireland is likely to attract some operations from companies based in the UK. According to the Industrial Development Agency, the agency promoting foreign investment in Ireland, there is a healthy pipeline of new projects.

Public investment is expected to provide only a small contribution to growth. While private investment is expected to underpin growth, public investment remains low and is only expected to increase moderately from 2017 on, according to government's plans. Total investment in housing and infrastructure has been severely depressed but emerging constraints could weigh on the growth potential of the economy.

Exports to the UK are forecast to suffer from the weakening of the pound sterling. The impact of the vote may reduce GDP growth in 2016 by a few percentage-point decimals mostly due to the weakening of sterling, which should lower Irish exports to the UK. Indigenous firms would be the most affected as they frequently price in pound sterling while multinationals price in US Dollars. Record profits in 2015 and experience in managing exchange rate volatility mean however that Irish firms are generally well positioned to withstand this shock. The impact is expected be more pronounced in 2017, if the sterling does not recover and the UK economy enters into a recession.

The moderation in employment growth is likely to continue. The unemployment rate should decrease at a slower pace than in earlier phases of the recovery. The labour force is expected to expand moderately, thanks to natural population growth and a return to net positive inward migration. The recovery in wages is projected to continue as the labour market tightens, though wage growth is not expected to match the productivity gains since 2008. The unemployment rate may fall less rapidly as heightened uncertainty following the UK referendum may have an adverse impact on economic activity.

Uncertainty following the UK 'leave' vote may dampen the recovery in inflation. Consumer price inflation could turn out marginally higher in 2016 than in the spring forecast due to higher oil prices. The impact of the 'leave' vote may somewhat dampen inflation rates in 2017 as the depreciation of sterling results in cheaper imports from the UK. In contrast with the price declines in traded goods, domestic price increases, mainly in services and rents, are expected.

Graph 2.8: **The general government deficit is expected to narrow further though risks remain.** Despite further tax cuts and expenditure increases of about EUR 1.5 billion (0.7% of GDP) in the 2016 budget, the Commission spring forecast projects the general government deficit to improve further this year to 1.1% of GDP, again benefitting from strong economic growth. On 21 June, in the Summer Economic Statement (SES), the first milestone of the 2017 budgetary cycle, the Irish government revised its deficit projections to 0.9% of GDP in 2016, 0.2 pp less than in the Stability Programme Update (SPU), due to better-than-expected tax

([28]) Economic and Social Research Institute, "Scoping the Possible Economic Implications of Brexit on Ireland" Research Series, Number 48, November 2015, Dublin. https://www.esri.ie/pubs/RS48.pdf

receipts ([29]). These numbers do not include latest revisions to GDP. The authorities will revise the budgetary forecast ahead of the 2017 Budget to reflect recently revised GDP data and to take into account the most recent fiscal developments. Based on a no-policy-change assumption, the Commission expects deficit to narrow further by 0.5 pps. of GDP in 2017.

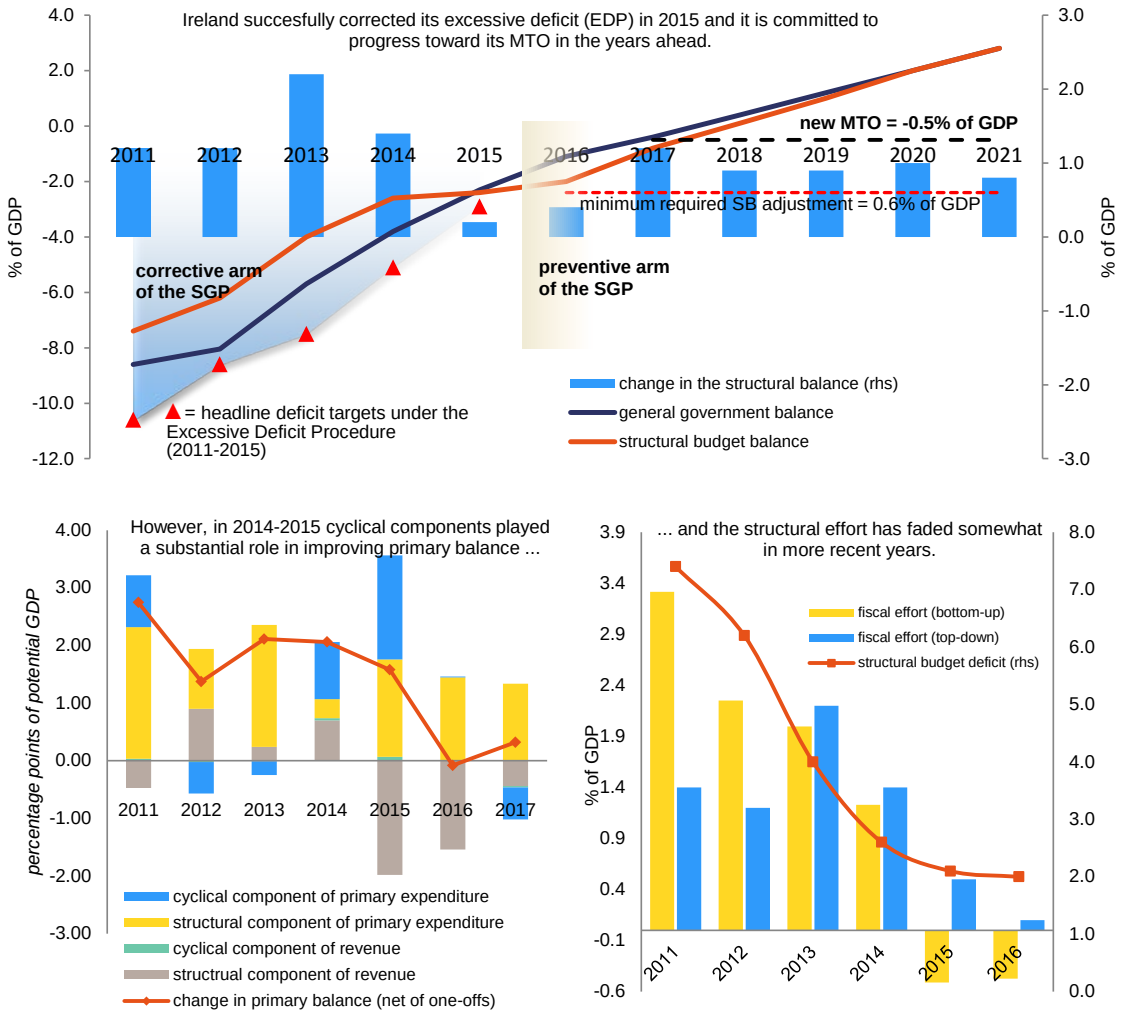
There are considerable downside risks to the Commission Spring 2016 fiscal forecast. This reflects the uncertainty surrounding the global economic outlook and, in particular, the impact of the UK 'leave' vote. The inability to control expenditure in health erodes confidence on planned budgetary targets. According to the Commission spring forecast, the structural budget deficit is expected to improve reaching close to 2% and 1% of GDP in 2016 and 2017 respectively, down from about 2⅔% of GDP in 2014 ([30]). This in part reflects the estimated budgetary impact of announced fiscal policy measures which have been specified in sufficient detail by the authorities and the rapid closure of the positive output gap in 2017.

Gross general government debt ratio is projected to continue falling. The recent upward revision to the level of GDP reduced the debt-to-GDP ratio to 78.8% in 2015, around 15 pps. less than had previously been estimated. By 2017, according to the Commission spring forecast, the government debt was projected to decline by a further 7 pps. This is mainly due to robust nominal GDP growth, low interest rates and the achievement of primary budget surpluses of 1.7% and 2.1% of GDP in 2016 and 2017 respectively. Sales of government-owned shares in the domestic banks would further reduce debt.

([29]) The revised projections take into account the additional EUR 540 million (c. ¼% of GDP) expenditure approved in June, largely on health, and higher-than-expected tax receipts, including social contributions, received in the year-to-date, estimated at around EUR 1 billion. Irish authorities will revise budgetary forecast further ahead 2017 Budget in account of latest national account data.

([30]) These numbers do not take into account recent revisions to GDP.

Graph 2.8: **General government deficit targets, cyclical vs. structural components and fiscal efforts**



(1) Figures in the top chart are taken from the Stability Programme 2016.
(2) The structural component of revenue and primary (excluding interest) expenditure in the bottom-left chart is obtained by adjusting the headline balance for the cyclical component and one-off measures. The adjustment is based on the commonly agreed EU methodology.
(3) The "top-down" and "bottom-up" metrics in the bottom-right chart refer to two complementary methods for the assessment of effective fiscal consolidation/action. The "top down" approach looks at the estimated change in the structural budget balance. The "bottom-up" approach consists of estimating, measure-by-measure, the budgetary impact of discretionary interventions on the revenue side and the expenditure side of the budget. The application of the two methods under the Stability and Growth Pact in the Code of Conduct on the "Specifications on the implementation of the Stability and Growth Pact and Guidelines on the format and content of Stability and Convergence Programmes".
Source: 2016 Stability Programme and Commission 2016 spring forecast

Table 2.1: **Main features of country forecast (spring 2016) – Ireland**

	2014			Annual percentage change					
	bn EUR	Curr. prices	% GDP	96-11	2012	2013	2014	2015 (*)	2016	2017
GDP		189.0	100.0	5.1	0.2	1.4	5.2	**7.8**	**4.9**	**3.7**
Private Consumption		83.8	44.3	4.4	-1.0	0.1	2.1	**3.5**	**2.7**	**2.0**
Public Consumption		32.4	17.2	3.8	-1.2	0.0	4.0	**-0.1**	**1.3**	**2.0**
Gross fixed capital formation		36.5	19.3	4.3	8.6	-6.6	14.3	**28.2**	**13.4**	**8.3**
of which: equipment		14.2	7.5	6.7	10.3	-8.1	27.2	**-8.3**	**8.0**	**11.0**
Exports (goods and services)		215.0	113.7	8.7	2.1	2.5	12.1	**13.8**	**6.9**	**6.6**
Imports (goods and services)		180.3	95.4	8.0	2.9	0.0	14.7	**16.4**	**7.7**	**7.4**
GNI (GDP deflator)		163.9	86.7	4.4	0.6	4.6	6.9	**5.6**	**4.9**	**4.0**
Contribution to GDP growth:		Domestic demand		3.7	0.8	-1.2	4.1	**7.1**	**4.3**	**3.1**
		Inventories		0.0	-0.3	0.2	0.5	**0.6**	**0.0**	**0.0**
		Net exports		1.6	-0.2	2.7	0.1	**0.1**	**0.6**	**0.6**
Employment				2.3	-0.6	2.4	1.7	**2.6**	**1.7**	**1.4**
Unemployment rate (a)				7.3	14.7	13.1	11.3	**9.4**	**8.2**	**7.5**
Compensation of employees / head				4.1	0.0	-0.7	1.8	**0.6**	**2.2**	**2.1**
Unit labour costs whole economy				1.3	-0.8	0.2	-1.6	**-4.2**	**-0.8**	**-0.1**
Real unit labour cost				-0.9	-1.1	-1.0	-1.7	**-9.0**	**-2.6**	**-1.3**
Saving rate of households (b)				-	8.3	6.1	5.0	**9.5**	**9.0**	**8.4**
GDP deflator				2.2	0.4	1.2	0.1	**5.3**	**1.8**	**1.2**
Harmonised index of consumer prices				2.3	1.9	0.5	0.3	**0.0**	**0.3**	**1.3**
Terms of trade goods				0.2	-6.4	0.3	-1.3	**5.2**	**0.3**	**-0.1**
Trade balance (goods) (c)				21.5	21.5	19.5	22.4	**30.1**	**30.7**	**31.7**
Current-account balance (c)				-1.1	-1.5	3.1	3.6	**4.4**	**4.6**	**4.6**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)				-0.7	-1.5	3.2	3.7	**4.5**	**4.7**	**4.8**
General government balance (c)				-3.0	-8.0	-5.7	-3.8	**-2.3**	**-1.1**	**-0.6**
Cyclically-adjusted budget balance (d)				-3.4	-6.2	-3.6	-2.8	**-3.2**	**-2.0**	**-1.0**
Structural budget balance (d)				-	-6.2	-4.0	-2.7	**-2.2**	**-2.0**	**-1.0**
General government gross debt (c)				47.6	120.1	120.0	107.5	**93.8**	**89.1**	**86.6**

(*) 2015-Q4 statistical release.
(a) As % of total labour force.
(b) Gross saving divided by gross disposable income.
(c) As a % of GDP.
(d) As a % of potential GDP.
Source: European Commission

3. POLICY ISSUES

3.1. PUBLIC FINANCES

3.1.1. Compliance with the Stability and Growth Pact

Ireland exited the excessive deficit procedure in 2015, following a sustained period of responsible fiscal management. The determination of the Irish authorities to stabilise the public finances has been a key pillar of Ireland's economic recovery as it assured citizens, businesses and investors that there would be no repetition of the mistakes of the past. Nevertheless, managing Ireland's inherent susceptibility to economic volatility will require a further rebalancing of the tax mix toward more sustainable and growth-friendly revenue streams while also maintaining stricter control over expenditure. In this context, Ireland's compliance with the Stability and Growth Pact will be essential to preserving the credibility of fiscal policy.

The Commission sees risks of a deviation from the recommended fiscal adjustment in 2016. In its assessment of the 2016 Stability Programme ([31]), the Commission concluded that there is a risk of some deviation from the required adjustment path towards the medium-term objective (MTO) in 2016 ([32]). The assessment does not take into account the latest revisions to GDP ([33]). Spending pressures are emerging, as illustrated by the additional EUR 540 million (0.25% of GDP) allocation to the 2016 expenditure ceiling, approved in June. Unexpected revenue surges, including from Central Bank surpluses, should be used to accelerate debt-reduction. The additional instability following the UK referendum result further emphasises the need for a cautious fiscal stance.

3.1.2. Expenditure control and resource allocation

The recent budget reform falls short of limiting discretionary changes to expenditure caps. The reform of the budgetary process – a key element of the Programme for a Partnership Government – gives greater coherence to the budget cycle, while also enhancing parliamentary engagement ([34]). However, it does not address the Commission's repeated calls for a reduction in discretionary changes of the expenditure ceilings. On the contrary, the budget reform seems to provide additional opportunities to adapt expenditure ceilings to the public finance situation, in particular with the introduction of a Mid-Year Expenditure Report.

The government plans additional spending increases and tax cuts in the 2017 Budget. In its Summer Economic Statement published on 21 June 2016, the government revised its fiscal strategy over the short and medium-term horizon ([35]). According to the statement, additional spending and tax cuts of around EUR 1.0 billion (0.4% of GDP) in 2017 will be possible while complying with the provisions of the Stability and Growth Pact ([36]). However, fiscal projections for later years are likely to be revised in light of the latest GDP figures and to take account of the impact of the UK referendum result.

([31]) The Commission's assessment of the 2016 Stability Programme for Ireland was published on 26 May. http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/20_scps/2016/07_ie_scp_en.pdf

([32]) The assessment is based on two pillars:
The structural balance (first pillar) is projected to improve by 0.2% of GDP in 2016, based on the Commission spring forecast. This implies a deviation of 0.4% of GDP from the recommended adjustment path (0.6% of GDP towards the MTO in 2016).
The growth rate of public expenditure net of discretionary revenue measures (second pillar) is expected to be below the reference rate, signalling compliance. Nevertheless, expenditure growth net of the 2015 one-off effects (the conversion of Allied Irish Bank (AIB) preference shares into common stock) would point to some deviation.
Therefore, the overall assessment indicates a risk of some deviation from the required adjustment path towards the MTO in 2016 and compliance in 2017.

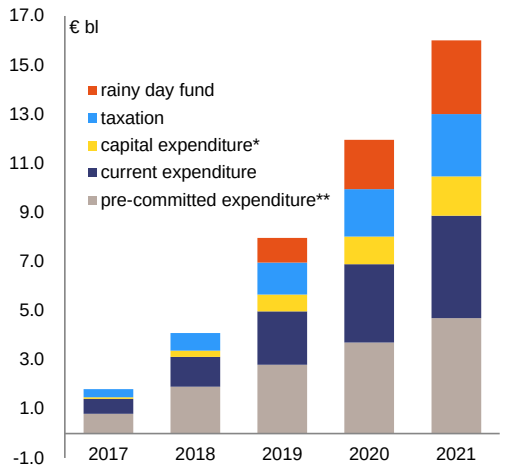
([33]) The extent to which the structural balance and the expenditure benchmark will be affected by the revision will mainly depend on the estimation of potential GDP and the output gap. The Commission will carefully consider any possible effects of GDP revision on the metrics underpinning the preventive arm of the SGP.

([34]) This issue has become prominent with the publication of the OECD *Review of Budget Oversight by Parliament: Ireland* in November 2015 ("the OECD report").

([35]) The government now forecasts that the deficit will fall to 0.9% of GDP in 2016 and to 0.4% in 2017, before achieving a balanced budget in 2018. However, these numbers do not take into account the latest revisions to GDP.

([36]) In its June 2016 Fiscal Assessment Report, the Irish Fiscal Advisory Council (IFAC) assessed that, in order to comply with fiscal rules, the combined value of tax cuts and spending increases introduced in Budget 2017 should not exceed approximately EUR 0.9 billion.

Graph 3.1: **Indicative allocation of available gross fiscal space 2017-2021**



* The Expenditure Benchmark applies a 4 year smoothing adjustment to capital formation. The total additional capital expenditure is estimated at EUR 5.14 billion.
** Total pre-committed expenditure reflects key demographic pressures, the Lansdowne Road Agreement, capital plans and certain other pre-committed policies.
Source: Summer Economic Statement (Department of Finance, Ireland)

Future resource allocation should prioritise public investment while ensuring sound public finance. The government plans to allocate an estimated fiscal space of around EUR 11.3 billion to reduce taxes (EUR 2.54 billion) and increase expenditure (EUR 6.75 billion) between 2017 and 2021, reflecting commitments in the Programme for a Partnership Government. However, additional current government expenditure will likely be absorbed by the delivery of existing services ([37]), and pressures to renegotiate public service pay may not be easily resisted. In turn this could erode the public capital budget which will remain subdued at just 2.7% of GDP in 2021 according to government's plans.

The establishment of a *rainy-day-fund* could provide a fiscal buffer during a future economic downturn. The government's plan to implement a contingency reserve with a EUR 1 billion contribution each year post-2018, has its merits, although it would compete with a faster debt-reduction strategy. Nevertheless, if appropriately designed, a *rainy-day-fund* could facilitate counter-cyclical fiscal policy and help to absorb future shocks. Fulfilling the government's intention to adhere to the Expenditure Benchmark rule even after the MTO has been achieved would be prudent and would limit the risk of windfall revenues being used to fund permanent spending increases.

3.1.3. Improving the tax base

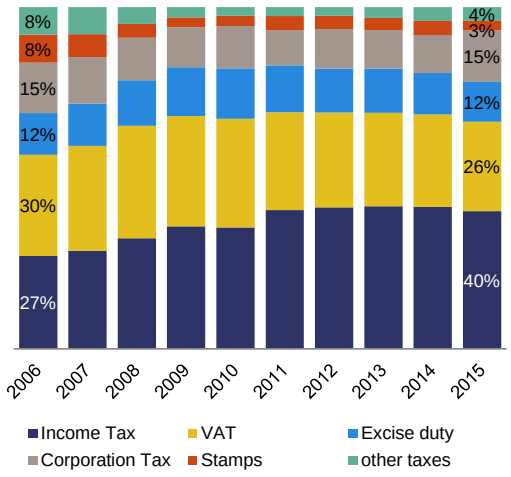
The gradual phase out the Universal Social Charge (USC) contrasts with the commitment to maintain a broad tax base ([38]). Plans to further reduce personal income tax through the phasing-out of the USC appear to be central in the new government's programme. However, the USC is a substantial and relatively stable source of revenue. Plans to phase-out the USC should carefully consider ways to maintain the existing breath of the personal tax base, given that the USC threshold of EUR 13.000 is currently the entry-point to personal taxation for most taxpayers ([39]). Maintaining a broad tax base is essential in order to limit the volatility of government tax revenues over the economic cycle.

([37]) See IFAC's Fiscal Assessment Report (June 2016).

([38]) The USC is a broad based tax on income that was introduced in January 2011, at the beginning of the Economic Adjustment Programme.

([39]) As results of tax credits and reliefs some 36% of income earners are currently exempt from income tax whereas approximately 29% are exempt from USC, according to analysis of the Department of Finance.

Graph 3.2: **Tax revenue contributions (as % of total tax)**



Source: Databank, Department of Public Expenditure and Reform, Ireland.

There is room for a rebalancing of the tax mix toward more sustainable and growth-friendly revenue. Personal income tax receipts now represent the single largest source of tax revenue at over 40%, while the share of VAT has fallen to around 26%, reverting to pre-crises contributions. Increasing revenue from environmental and property taxation, and elimination of reduced value-added tax rates could help to both broaden the tax base, and enhance the growth and environmental friendliness of the tax system.

Revenue from value added tax (VAT) is low compared with other Member States, largely as a result of the size of the VAT policy gap ([40]). There is still no systematic process for evaluating the costs and benefits of reduced VAT rates in Ireland, in contrast with the regular reviews of other tax expenditures. However, the authorities have recently released a report on the reduced rate of VAT for hotels and restaurants. The report highlighted the change in economic circumstances in the period since the reduced rate was introduced. Restoring the standard VAT rate to hotels and restaurants could deliver an additional EUR 600 million in revenue ([41]).

The authorities have avoided increasing revenues from immovable properties. A revaluation of self-assessed property values used to calculate local property tax liabilities was planned for 2016, but has been delayed by three years to November 2019. This represents a lost opportunity to broaden the tax base as residential property prices have increased substantially since the first self-assessment in 2013. Increasing the share of revenue from recurrent taxes on residential property could encourage more efficient land use.

The volatility of corporate income tax (CIT) in recent years demonstrates the risk to Ireland's public finances arising from changes to international tax standards and practices. Transactions in intellectual property by MNEs are the source of the recent spike in investment. This may be a response to the OECD Base Erosion and Profit Shifting (BEPS) initiative, changes in residency rules aimed at preventing the use of the "double Irish" tax avoidance scheme, or the recent introduction of the knowledge development box tax incentive for research and development.

The substantial and often opaque activities of MNEs could also be a source of shocks to the economy. Although a key pillar of Ireland's long-term economic development strategy, MNEs contribute to the volatility of fiscal revenues. This was highlighted by the very rapid increase in corporate tax revenue observed in 2015. Moreover, changes in the international taxation regime are possible, not least as a result of the Commission's new tax transparency initiative and the re-launched discussions on the Common Consolidated Corporate Tax Base (CCCTB). Finally, Ireland's EU budget contribution will increase due to the large revision to GNI. However, this should also be seen in the context of the large increase in CIT receipts as all are related to the activities of MNEs.

([40]) The VAT policy gap reflects the additional revenues that a Member State could collect in theory if it applied uniform taxation to all consumption, without reduced rates or exemptions.

([41]) Tax Strategy Group – TSG 16/04 http://www.finance.gov.ie/sites/default/files/160711%20TSG%2016-04%20Selected%20issues%20in%20VAT.pdf

3.2. MACRO-FINANCIAL

3.2.1. Financial sector

Average Irish mortgage interest rates remain higher than the euro-area average and the banks are under pressure to reduce them. Draft legislation proposed by Fianna Fáil aims to enable the CBI to periodically review the market for residential mortgage loans and, if a "market failure" is identified, to introduce a cap on mortgage interest rates. In spite of the CBI indicating that it would be reluctant to use such power, this policy proposal is already undermining investor confidence, as reported by the banks. It may discourage potential new entrants into the market, and it is not helping the prospect of a state divestment in banks. The pricing of loans in Ireland is largely a reflection of legacy issues such as the banks' substantial holdings of low-yielding tracker mortgages and high non-performing loans (NPLs). It may also reflect a lack of competition in the market and difficulties in accessing collateral. With regard to the views of the ECB on this matter, the government has acknowledged that there is an obligation to consult the ECB on this draft legislation, and the ECB is expected to publish a detailed opinion on the matter following such consultation ([42]).

The restructuring of accounts in arrears remains subject to enhanced scrutiny. There is a time lag between resolution activities and NPL reduction as accounts need to remain performing for some time, conventionally one year, before being removed from the NPL statistics. The Single Supervisory Mechanism (SSM) is currently undertaking a report which will put further emphasis on reducing NPLs from their current high levels.

Mortgage restructuring strategies vary between banks and the share of short-term arrangements is still considerable. Solutions that include debt right-sizing, such as split mortgages, are more common now, but are still under-used. In spite of the progress achieved, there are still many accounts on which no payments have been made in several years. While banks are encouraged to keep re-engaging with all debtors, a certain proportion of these accounts can only be resolved through repossessions. However, the repossession of collateral remains a difficult and lengthy process in Ireland due to numerous adjournments.

The insolvency framework is being strengthened further. Courts have been given the power to approve insolvency deals rejected by lenders. The bankruptcy term has been reduced from 3 years to 1 year. After a pilot phase, the Money Advice and Budgeting Service (MABS) court support is expected launched nationally in December 2015. In addition, the Aid and Advice Scheme providing initial free advice for debtors started in July 2016 ([43]). The Programme for Partnership for Government contained a proposal for the creation of specialized courts for mortgage arrears and insolvency proceedings. As an immediate measure, from September 2016, Circuit Court repossession procedures will take place on specified days at dedicated court venues and with specific judges. Moreover, several new initiatives were announced: a new national service standardising supports available to those in mortgage arrears, a review the thresholds and the processes for Personal Insolvency Arrangements, the retention of mortgage interest relief beyond the current end date of December 2017 and an amendment of the Code of Conduct on Mortgage Arrears (CCMA).

The implementation of the central credit register (CCR) has been delayed again, due to data protection issues. The CCR remains a crucial element for improved future lending standards and is a prerequisite for a more precise calibration of certain macroprudential measures. While its technical development has been progressing according to the last (revised) schedule, the project will not progress further until

([42]) In the meantime, the CBI has amended the Consumer Protection Code, requiring banks to provide detailed information on their policy for setting and/or increasing variable mortgage interest rates and to inform variable mortgage holders on any alternative option that could provide savings for the borrowers.

([43]) Through the Aid and Advice Scheme debtors in arrears have access to free financial advice and assistance, either by a MABS adviser or by a panel personal insolvency practitioner (PIP) or panel accountant. Where a legal issue is identified, or where the borrower is facing repossession proceedings, they can also avail of free legal advice and assistance by a panel solicitor. The Scheme aims to assist debtors to identify and put in place sustainable long term solutions, and is to last 3 years with reviews each 6 months.

the data protection concerns are addressed and the necessary regulations are made ([44]).

Irish banks operate under robust supervisory oversight, with the European bank resolution framework now also in place. The supervisor maintains its granular monitoring of non-performing loan resolution and provisioning practices. It undertook several bank-specific on-site inspections targeting issues such as cyber risk, governance and contingency plans related to the UK referendum. Interlinkages of domestic lenders with other financial intermediaries and multinational companies remain limited, but within the remit of the supervisor. Finally, uncertainty on modalities for the support of failing banks will be removed through the implementation of the Bank Recovery and Resolution Directive (BRRD) and the Single Resolution Mechanism (SRM).

A detailed review of the macroprudential measures for mortgage lending will be published by the CBI at the end of November 2016. The tools currently in place ([45]) will be evaluated to assess the progress toward increasing household resilience and curbing pro-cyclicality, as well as potential side-effects on housing supply, rental market, prices and expectations. In order to better monitor developments in the commercial real estate (CRE) market, the CBI, National Asset Management Agency (NAMA) and the Central Statistics Office Ireland (CSO) will be developing a national commercial property statistical system (CPSS) over a period of approximately two years. In addition, the authorities have asked the CBI to assess a possible off-setting measure, the "capacity to pay test", based on rental payments made by prospective buyers in the past.

([44]) Because of changes in the regulatory landscape that in part result from recent European Court of Justice (ECJ) rulings, the CBI needs to demonstrate the necessity and proportionality of personal data collection, including the use of the personal public service number (PPSN) as the identifier and the reporting threshold of EUR 500.

([45]) The toolbox has been in place since February 2015 and consists of loan-to-value limits of 80% for primary dwelling housing (90% for first time buyers) and 70% for buy-to-let properties. In addition, there is a loan-to-income limit of 3.5 for primary housing loans. Banks have small discretionary buffers not subject to these limits. The CBI also has a number of other macro prudential measures available under the CRDIV/CRR. One such example is the Other Systemically Important Institutions (O-SII) capital buffer as announced in December 2015. Lastly, the counter-cyclical buffer on Irish exposures came into effect in January 2016, and has been set at zero percent since.

In spite of the limited choice of bank lenders and the high cost of borrowing, SME credit demand is starting to recover (see Graph 2.8). The essentially two-bank market is characterised by interest rates higher than the euro-area average. This is one reason why investment is mostly being financed by retained earnings and own funds. New regulation, strengthening protection of SME borrowers, in effect since July 2016, aims to increase transparency during the credit application process, spur engagement with debtors in difficulties and expand grounds for a rejection appeal. Lenders' compliance will be monitored.

There is scope for greater use of Strategic Banking Corporation of Ireland's (SBCI) financing ([46]). As of July 2016, the SBCI has committed the earmarked EUR 800 million to seven on-lenders, of which EUR 347 million has been lent out - provided to the market for financing.. As credit demand recovers its aim will be to attract more on-lenders in order to spur competition in the market. To this end, the SBCI has secured an additional funding of EUR 250 million from the National Treasury Management Agency (NTMA) to enable it to enter new funding agreements.

3.2.2. Commercial Real Estate (CRE)

Rapid growth in commercial real estate (CRE) values continues but is not driven by credit from domestic banks. Rather, CRE investment is mostly funded by foreign equity investors. Nevertheless, CRE prices are volatile and a sudden fall in prices could have an adverse effect on the economy, especially if the share of domestic bank financing increases. In this context, the joint CBI, CSO and NAMA initiative to develop official CRE statistics is most welcome as it would facilitate the monitoring of risks in the sector. This is particularly relevant in view of the remaining CRE exposures of domestic banks. Although evidence of overvaluation is inconclusive at present, macro prudential tools targeting banks' CRE exposures could be implemented in the form of sectoral

([46]) The SBCI was set up in 2014 to source low cost long-term finance from domestic (NPRF) and multilateral finance providers (KfW, EIB) and to lend these funds to Irish SMEs via qualifying on-lenders. It is a Designated Activity Company in which the Minister for Finance is the sole shareholder. The Minister has also provided guarantees to support the KfW, EIB and NTMA loans.

capital requirements if the authorities deemed it appropriate.

3.2.3. Residential Real Estate

Despite the efforts of the previous administration, undersupply of housing remains a prominent issue. In addition to severe social consequences, including homelessness, the shortage of housing may also have an adverse impact on competitiveness, undermining Ireland's ability to attract continued inward investment and skilled immigrants. Although many policy responses have been put forward, ultimately, the provision of adequate supply is the only durable solution to the issues currently afflicting the housing market in Ireland.

One critical element of the previous government's attempt to address supply constraints was the introduction of less onerous national planning guidelines for apartments. This followed extensive criticism of the previous standards on the grounds that they had increased the cost of construction to the point where new development was no longer profitable. Evidence of a supply response to this reform is limited so far, although it is likely that it will take more time for the measure to have an impact.

The government published Rebuilding Ireland: Action Plan for Housing and Homelessness on the 19 July ([47]). The incoming government has created a new Ministry for Housing with the aim of coordinating the broad array of proposed and existing policy measures. The new plan includes measures, such as the introduction of a tax based "help to buy" scheme for first time buyers. Full details of the measure are due to be announced on Budget day including eligibility criteria. As well as being costly, demand side measures could be counterproductive given current supply constraints.

A key pillar of the Action Plan is a substantial expansion of the direct provision of social housing units. The Infrastructure and Capital Investment Plan (2016-2021) contained a commitment for the direct provision of an additional 35,000 social housing units over the five years to 2021, and this has now been increased to 47,000 units requiring an estimated EUR 5.35 billion in funding ([48]). This represents a EUR 2.2 billion increase on the previous plans and social housing will now account for 43% of capital spending over the next four years. Current supply constraints add weight to arguments in favour of increased social housing construction. However, in the long run direct provision of social housing may, without complementary reforms to the social housing system, still be more expensive than provision via the private rental market ([49]).

The government is exploring the potential of "off-balance sheet" mechanisms as a means to facilitate further increases in social housing investment. In this context, the creation of a Special Purpose Vehicle (SPV) in early 2017 is envisaged. The aim of the SPV would be to acquire vacant units and lease them to local authorities and approved housing bodies. Whether such an SPV would satisfy commerciality and off-balance sheet criteria is subject to an assessment by Eurostat on a case by case basis ([50]).

The Action Plan aims to create a EUR 200m Local Infrastructure Housing Activation Fund. This aims to contribute to the delivery of transport, water, and other infrastructure essential to facilitate an increase in housing supply. The government suggests that it will expedite the development of a number of large urban sites with the capacity to deliver up to 20,000 new homes. According to the Dublin Housing Supply Task Force, planning permissions for almost 27,000 homes have already been granted in Dublin but less than 5,000 of these are actually under construction. Providing infrastructure investment supporting housing could be an effective and

([47]) Rebuilding Ireland: Action Plan for Housing and Homelessness. http://rebuildingireland.ie/Rebuilding%20Ireland_Action%20Plan.pdf

([48]) To support this acceleration and expansion of social housing development a new Housing Delivery Office will be established within the Department of Housing, Planning, Community and Local Government, while a new "procurement centre of excellence" will be created within the Housing Agency.

([49]) National Social and Economic Council (2004) Housing in Ireland: Performance and Policy http://files.nesc.ie/nesc_reports/en/NESC_112_2004.pdf

([50]) It should be noted that NAMA already operates an SPV (National Asset Residential Property Services) that is somewhat comparable to what is proposed in that it provides units used for social housing and that it is not currently categorised under general government.

targeted means of addressing the housing supply shortage in urban areas in the short to medium term.

Market participants propose introducing a reduced (9%) VAT rate for construction materials. Industry groups have argued for a reduced rate as they estimate that VAT costs are over EUR 36,000 for a typical Dublin semi-detached housing unit ([51]). The additional housing units completed as a result of such a measure are as likely to be in distant areas of commuter counties as in spatially appropriate locations in Dublin. Moreover, according to the Economic and Social Research Institute (ESRI) such a measure would have a limited impact on supply ([52]). A reduced (9%) VAT rate for construction materials would be relatively expensive, as it is estimated that it could cost approximately EUR 200 million per annum if it applied to all housing units constructed in Ireland.

The Action Plan for Housing and Homelessness includes an array of measures aimed at tackling homelessness but acknowledges the fundamental link between homelessness and supply shortages. New rental market measures include a 15% increase in the rent supplement and housing assistance payment (HAP) which should provide extra financial assistance to people at risk of becoming homeless. Among other measures to address homelessness is a target to construct 1,500 Rapid Build Housing Units, while the Housing Agency will seek to acquire 1,600 vacant houses.

The Action Plan for Housing and Homelessness contains further proposals for the reform of the rental sector, although actions remain limited to date. This includes the publication of a new rental strategy document by the fourth quarter of 2016, which will be structured around four key areas: security, standards, supply and services. Reform of the rental sector has become increasingly urgent as the proportion of the population renting has increased rapidly in recent decades. The outgoing government's effort to control rent increases by reducing the maximum frequency of rent reviews to once every two-years has not prevented substantial further rent increases in 2016.

3.3. STRUCTURAL REFORMS

3.3.1. Labour activation

The recommended increase of the minimum wage for 2017 is not expected to have a significant adverse impact on employment. In its July report, the Low Pay Commission recommended an increase in the minimum wage from EUR 9.15 to EUR 9.25 per hour in 2017 ([53]). However, the government has recently announced plans to increase the minimum wage more substantially from EUR 9.15 to EUR 10.50 per hour over the next five years. The employment impact of introducing the latter measure should be subject to additional analysis. At the same time, it is also committed to review a pay-related social insurance (PRSI) scheme for the self-employed.

The reform of activation support for long-term unemployed people is well underway but its effectiveness still needs to be assessed. Changes to activation processes and institutions are now virtually complete with the full implementation of the *Intreo* ([54]) and *JobPath* ([55]) programmes aimed at improving support to jobseekers. A number of impact assesments are currently under way, including for *Intreo*. Given the wide array of measures introduced, it will be important to assess their effectiveness, particularly for more resource-intensive activation programmes and their efficiency in addressing the skills mismatch issues.

3.3.2. Healthcare system

Spending pressures in the healthcare system persist. In the year to June the health expenditure overrun was around EUR 138 million, 2.1% above budget allocation. This required a supplementary EUR 500 million in exchequer funding for 2016. It will primarily be directed toward maintaining the

([51]) Society of Chartered Surveyors Ireland: The Real Cost of Housing Delivery. https://www.scsi.ie/documents/get_lob?id=885&field=file

([52]) Analysis of Property Tax Options https://www.esri.ie/publications/analysis-of-property-tax-options/

([53]) Recommendations for the National Minimum Wage. http://www.lowpaycommission.ie/here-.pdf

([54]) Intreo is the single point of contact for all employment and income supports of the Department of Social Protection.

([55]) JobPath is a payment-by-results contracted service which offers intensive individual assistance to the long-term unemployed (over 12 months) in overcoming barriers to employment and finding jobs.

existing levels of the services in areas such as acute, mental health and disabilities sectors, and the Primary Care Reimbursement Service (PCRS), and to cover the overspending for this year. The extra allocation is conditional on an enhanced governance and accountability framework, and the health service managers will be held responsible for the performance within their budget.

Cost-effectiveness of the health sector remains a central challenge. Although structural reforms in the healthcare sector continue to advance (see 2016 Country Report), cost-effectiveness in the delivery of healthcare services remains sub-optimal as expected cost-saving measures have not been fully implemented. Achieving price reductions in the on-patent group is key to generate overall savings. The Health Service Executive (HSE) has reached an agreement with the Irish Pharmaceutical Healthcare Association (IPHA) on the supply and pricing of medicines. The agreement is estimated to reduce the price HSE pays for medicine and deliver an estimated EUR 700 million in savings over four years. It also includes an annual price realignment aimed at further reducing the price of medicines. On the other hand, the authorities no longer intent to mandate the prescription of international non-proprietary name (INN) medications.

Healthcare reforms remain at the forefront of the policy debate but the transition towards a universal health insurance system is only progressing slowly. Previous plans to replace the two-tier system with the universal health insurance (UHI) have been put on hold after an assessment by the ESRI found that the cost of supporting such a system would be too high. Building on this work, a committee will be established to develop a 10 year plan for the health service. The activity-based funding (ABF) is still only operating in the 38 largest public hospitals and a review of the system is planned for 2017. Similarly, the *eHealth* strategy and the establishment of individual health identifiers will take time. These reforms are essential for the efficient delivery of public services and they should continue independently of the UHI uncertainty.

3.3.3. Water sector

Uncertainty about the future of Irish Water persists. The government and the opposition have agreed to retain Irish Water as a single national utility in public ownership in charge for delivery of water and wastewater services. However, the charges have been suspended for a period of nine months starting from April 2016, with the possibility of extension if an agreement is not reached ([56]). An External Advisory Body will be established to advise on the transparency and accountability of Irish Water. Furthermore, an expert commission has been appointed, consisting of national and international experts, to investigate and provide recommendations on a sustainable long-term funding model for Irish Water ([57]).

Changes to the structure of Irish Water could have a fiscal cost and negatively affect the utility's operations. Irish Water is now classified within the general government accounts and this will have a budgetary impact. The revenue forgone from nine month suspension of water charges is estimated to be EUR 145 million. These costs would be largely offset by the parallel suspension of the water conservation grant. Therefore, the authorities expect no major impact on the fiscal balance from the suspension in 2016, but it is not clear what will happen in future years. There is still uncertainty on whether to refund the charges already paid, around EUR 155 million in the year to May 2016, and its impact on the fiscal balance. Furthermore, as of 2016, future investments in Irish Water fall within the constraints imposed under the Stability and Growth Pact framework (SGP) and therefore it may delay necessary infrastructure investment highlighted in the Irish Water's Strategic Plan and Business Plan.

([56]) The suspension of charges may interfere with Ireland's compliance with the Water Framework Directive (WFD). In 2010 Ireland agreed to comply with Article 9 of the WFD and subsequently committed to implement water charges. The Commission considers that the Directive does not provide for a situation where Ireland can apply for an exemption under Article 9, as stated in the Commission's position regarding a possible reversion from charges, response to written question E-004707/2016.

([57]) The recommendations of the expert commission, which are expected after five months of its establishment, by the end of November 2016, will be considered by the Special Oireachtas Committee which will endeavour to make its own recommendations to the Oireachtas within a period of three months. These recommendations will be voted upon by the Oireachtas within a one month period.

4. SOVEREIGN FINANCING AND CAPACITY TO REPAY

The sovereign's financing situation is expected to remain reasonably comfortable. At the end of 2015, the sovereign had EUR 10.9 billion in cash and other liquid assets and it expects to hold a broadly similar amount at the end of 2016 (Table 4.1). The National Treasury Management Agency (NTMA) plans to issue between EUR 6 and EUR 10 billion in long-term government bonds in 2016. This is less than in previous years due to trends in the cash deficit and issuance in 2014-2015 being higher than usual due to the early IMF repayments. At end-June 2016, the NTMA had already issued EUR 5.6 billion in long-term debt through syndication, bond auctions and the issuance of Ireland's first 100-year note in March ([58]). The agency has, in recent years, been covering projected funding needs approximately twelve months in advance but is now transitioning to a shorter horizon reflecting the improving fiscal position and debt profile. Over the period of May-July 2016, the NTMA cancelled EUR 1,000 million of a floating rate treasury bond due to mature in 2041 by purchasing them from the CBI. This bond was issued in connection IBRC and its balance outstanding has now been reduced to zero.

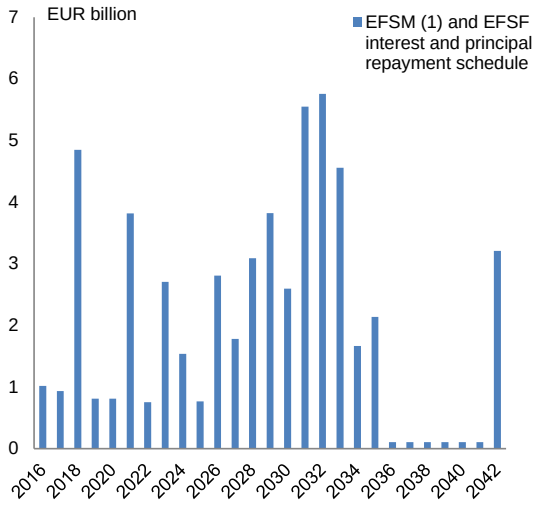
Under the ECB's expanded asset purchase programme (APP), the CBI purchases government bonds and other eligible securities. It does so in line with its capital key share of the Eurosystem monthly asset purchase volume objectives. The CBI can purchase close to EUR 1 billion of Irish government bonds and other eligible securities per month and held over EUR 12 billion (5.2% of GDP) of securities at end-June 2016 ([59]). The central bank is expected to purchase close to EUR 5 billion of eligible securities in the remainder of 2016. As of 1 April 2016, the combined monthly purchases under the APP increased to EUR 80 billion from EUR 60 billion for the euro area as a whole, following the decision of the ECB in March 2016. The APP is scheduled to continue until at least the end of March 2017.

([58]) The NTMA issued a EUR 100 million note, maturing in 2116, at a yield of 2.35%. It was sold by private placement via two of the NTMA's primary dealers.

([59]) The ratio to GDP includes information from the revised CSO National Income and Expenditure Annual Results 2015 released on 12 July.

Market volatility has been remarkably low for the Irish sovereign in the aftermath of the UK referendum. Both yields and spreads on 10-year bonds remained fairly stable and have significantly declined since, signalling continued market confidence in the country. Debt issuance and budget execution are progressing as planned and, with large cash buffers and limited financing needs over the next twelve to fifteen months, the sovereign is in a good position to withstand potential volatility in markets. While uncertainty surrounding the future of the UK is expected to have a negative impact on the Irish economy, GDP is expected to continue growing at robust rates.

Graph 4.1: **EFSM and EFSF repayment schedule**



(1) Ireland is expected to request the maturity extension of other EFSM loans as they become due in the future.
Source: EFSM and European Commission

The repayment risks for the EFSM and EFSF loans remain low over the medium term. This assumes that the authorities continue to implement fiscal consolidation, financial sector policies and structural reforms, while access to capital markets is maintained. The general government debt ratio is expected to continue declining. The average maturity of public debt in Ireland is one of the longest in Europe, with approximately 40% of medium/long-term debt maturing from 2026 onwards. The redemption profile of EFSF and EFSM loans to Ireland currently extends until 2042, with the next principal repayment technically due in 2018 (Graph 4.1). However, owing to the maturity extensions granted in 2013,

Table 4.1: **Government financing plans**

EUR billion	2015 Provisional Outturn	2016 Estimate
Funding requirement		
Exchequer borrowing requirement (EBR) (1)	0.1	1.5
Medium/long-term debt redemption (2)	14.7	7.3
Other (3)	0.0	3.4
Total requirement	**14.8**	**12.2**
Funding sources		
Government bonds (4)	13.7	9.0
Net short-term paper funding	-1.7	0.6
Other (5)	2.6	2.1
Use of cash and other short-term investment balances (- represents an increase)	0.2	0.5
Total sources	**14.8**	**12.2**
Financial buffer (6)	**10.9**	**10.4**

(1) 2016 EBR estimate as per Department of Finance, Stability Programme Update (April 2016).
(2) Includes bond maturities. 2015 figure also includes early IMF loan repayments, bond purchases and switches.
(3) Includes bond purchases - including the early purchase of the 4.6% treasury bond 2016 in February and the 2041 FRN in March - bond switches and contingencies.
(4) In its Funding Statement for 2016 issued on 22 December 2015, the NTMA announced that it plans to issue EUR 6 - EUR 10 billion of government bonds in 2016. EUR 9 billion is used as an indicative amount in this presentation.
(5) Includes net state savings (retail), other medium/long-term funding and, in 2016, rebate of pre-paid margin on initial EFSF drawdown in 2011.
(6) End-year cash and other short-term investment balances. Excludes Housing Finance Agency (HFA) guaranteed notes and CSA collateral funding balances.
2015 figures are provisional outturns, and therefore subject to revision. 2016 figures are estimates as of April 2016. Rounding may affect totals.
Source: National Treasury Management Agency

the 2018 EFSM maturities are expected to be refinanced ([60]). The average effective interest rate on general government debt is estimated to be below 3.5% in 2016. Total interest payments due on EFSF and EFSM loans in 2016 will be close to 0.4% of GDP.

([60]) On 21 June 2013, the Council adopted Implementing Decision 2013/313/EU to increase the average maturity of EFSM loans to Ireland to by seven years to 19.5 years. Thus, Ireland has the option to request that any maturing tranche under its EFSM loans be extended. This needs to be formally notified four months prior to the relevant expiry date.

ANNEX 1

State of play with Macroeconomic Imbalance Procedure (MIP) relevant recommendations

ANNOUNCED MEASURES	ADOPTED MEASURES	IMPLEMENTED MEASURES	SOURCE OF COMMITMENT
Public finance and taxation			
Fiscal policy and fiscal governance			
• In its Summer Economic Statement (SES) published on 21 June 2016, the government announced additional spending and tax cuts of around EUR 1.0 billion (0.4% of GDP) in 2017 Budget. The apportioning will follow the 2:1 split between public spending increases and tax reductions as set in the "Programme for a Partnership Government". The proposed budget strategy for 2017 set out in the SES is not expected to change materially following the result of the UK's referendum on EU membership.	• In 2016, The Commission sees risks of a deviation from the recommended fiscal adjustment. Based on the Commission 2016 spring forecast, the structural balance (first pillar) is projected to improve by 0.2% of GDP in 2016. This implies a deviation of 0.4% of GDP from the recommended adjustment path (0.6% of GDP towards the MTO in 2016). • As for the second pillar, the growth rate of public expenditure net of discretionary revenue measures is expected to be below the reference	• Ireland corrected its excessive deficit in 2015. Since 2009, when the deficit peaked at around 11.5% of GDP (excluding deficit-increasing one-off measures related to financial sector support), the general government balance has steadily improved, with the deficit declining to 3.7% of GDP in 2014 and to 1.8% of GDP in 2015. The deficit is set to remain below the Treaty reference value of 3% of GDP over the forecast horizon. On 17 June, the Council adopted the decision to abrogate the excessive deficit procedure for Ireland.	**CSR 1 – 2015** • Ensure a durable correction of the excessive deficit in 2015. • Achieve a fiscal adjustment of 0.6 % of GDP towards the medium-term budgetary objective in 2016. • Use windfall gains from better-than-expected economic and financial conditions to accelerate the deficit reduction and debt reduction. • Limit the existing discretionary powers to change expenditure ceilings beyond specific and predefined contingencies.

	rate, signalling compliance. Nevertheless, expenditure growth net of the 2015 one-off effects (the conversion of Allied Irish Banks' preference shares into common stock) would point to some deviation. Therefore, the overall assessment indicates a risk of some deviation from the required adjustment path towards the MTO in 2016 and compliance in 2017. • In June 2016, the Government approved a supplementary budget allocation of EUR 540 million (0.25% of GDP) to the 2016 expenditure ceiling mostly on health. Such revisions affect the underlying purpose of expenditure ceilings, specifically: to anchor government expenditure over the medium term and to avoid pro-cyclical expenditure policies.		

	• Part of very significant revenue windfalls from much stronger than expected economic growth, including the exceptional surge of corporate tax receipts, are being used to finance increased permanent expenditure and tax cuts in 2015 and 2016, rather than to accelerate the reduction of still high government debt.		
Broaden the tax base			
• In its SES, the Government committed to measures including: – Reducing marginal tax rates on labour, including by phasing out the Universal Social Charge (USC). – Increasing the Earned Income Tax Credit for the self-employed to match the pay as you earn (PAYE) credit by 2018.	• Measures implementing internationally agreed efforts to reduce tax avoidance can contribute to broadening the tax base. • The changes to the USC and the introduction of further tax credits in budget 2016 are likely to further narrow the tax base. However, the decision not to increase the income tax bands	• While the full impact of the gradual phase-out of the double Irish tax scheme may not be fully apparent in the near term, it has the potential to broaden the tax base by eliminating firms ability to use the scheme to reduce their tax liabilities.	**CSR 1 – 2015** • Broaden the tax base and review tax expenditures, including on value-added taxes (VAT).

– Introducing a pay related social insurance (PRSI) scheme for the self-employed. – Reducing the rate of Capital Gains Tax for new start-ups to 10% from 2017. – Maintaining Ireland's Corporation Tax rate at 12.5% and monitoring how the Knowledge Development Box is promoting the development of knowledge-based capital in Ireland. • These measures will be funded inter alia by: – Increasing revenue by not indexing tax credits and bands. – Removing the PAYE tax credit for high earners to further enhance the progressivity of the income tax system. – Funding part of the increase in expenditure by increasing taxation to promote healthy	will somewhat broaden the tax base. • The decision to postpone by two years the revaluation of self-assessed property values, used to calculate local property tax (LPT) liabilities, represents a lost opportunity to broaden the tax base. • No other measures have been taken to broaden the tax base. The Irish authorities completed a rolling programme of tax expenditure reviews and published an updated report in this regard in 2015. However, the review process does not cover VAT related tax expenditures.		

lifestyles, for instance by taxing sugar sweetened drinks. • It is likely that the latter measures will neither maintain the breadth of the tax base, nor fully compensate for the revenue losses associated with the reductions in taxes on labour. • In isolation, any phasing out of the USC will hinder the commitment to maintain a broad tax base.			
Financial sector			
Financial services			
• In the "Programme for a Partnership Government" several initiatives were announced: – A new national service standardising supports available to those in	• The implementation of the central credit register (CCR) has been delayed again, due to privacy and data protection issues. While its technical development has been progressing according to the last (revised)	• Since November 2015, courts have been given the power to approve insolvency deals rejected by lenders, effectively removing the "bank veto". • Since January 2016, the bankruptcy term has been reduced from 3 years to 1	**CSR 4 – 2015** • Finalise durable restructuring solutions for a vast majority of mortgages in arrears by end-2015 and strengthen the monitoring arrangements by the Central Bank of Ireland (CBI). • Ensure that restructuring solutions for loans to

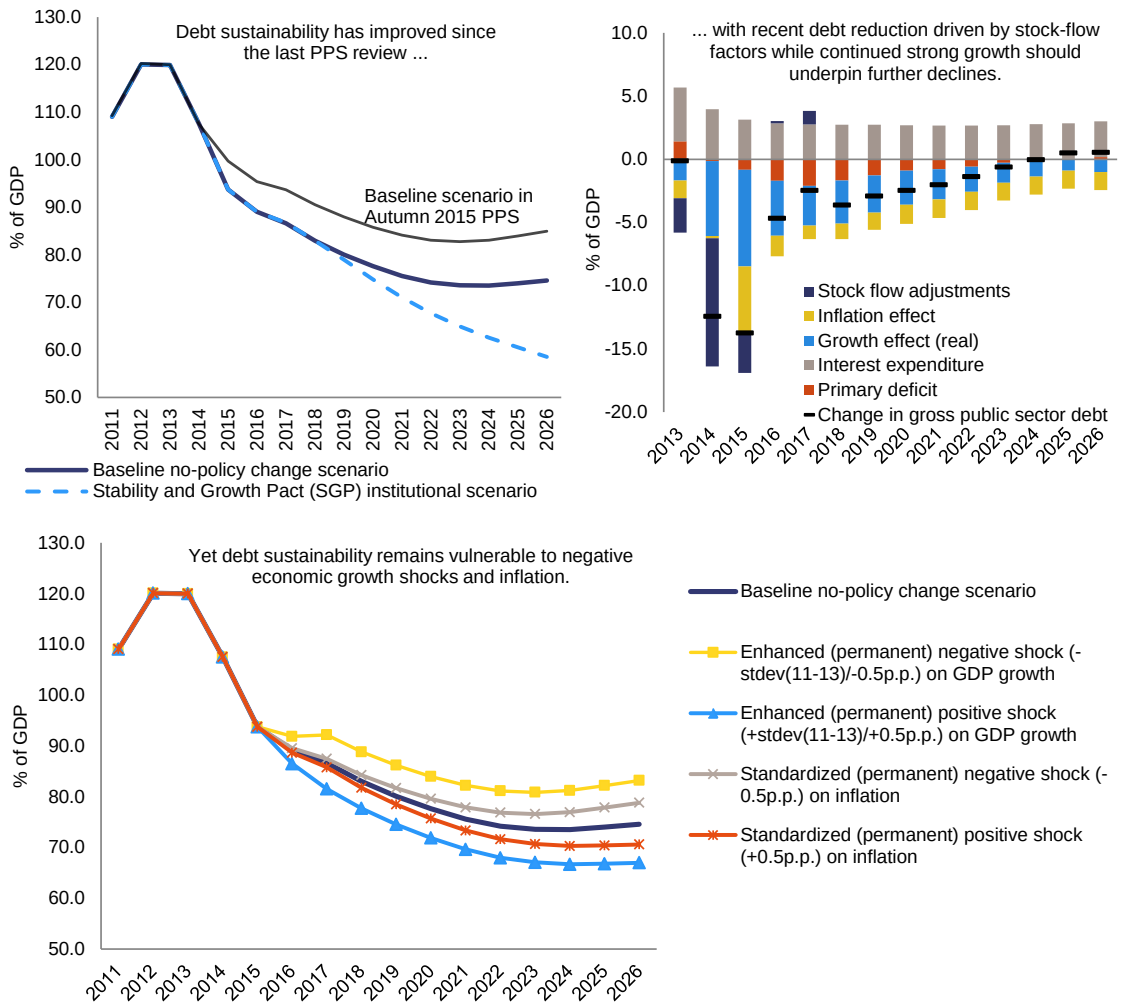
mortgage arrears. – A review of the thresholds and the processes for Personal Insolvency Arrangements. – The retention of mortgage interest relief beyond the current end date of December 2017. – An amendment of the Code of Conduct on Mortgage Arrears (CCMA). • The Programme for Partnership for Government contained a proposal for the creation of specialized courts for mortgage arrears and insolvency proceedings. As an immediate measure, from September 2016, Circuit Court repossession procedures will take place on specified days at dedicated court venues and with specific judges. • In the Action Plan for Housing and Homelessness, EUR 1.5 billion are earmarked for a 2017	schedule, the project will not progress further until the data protection concerns, arising from changes in the regulatory landscape, are addressed. More specifically, the CBI needs to prove the necessity and proportionality of personal data collection, including the use of the personal public service number (PPSN) as identifier, and the reporting threshold of EUR 500. • After a pilot phase, the Money Advice and Budgeting Service (MABS) support for court proceedings is expected to launch nationally shortly.	year, with extension of up to 3 years in certain circumstances. • Since July 2016, through the Aid and Advice Scheme debtors at risk of losing their homes due to mortgage arrears have access to free financial advice and assistance, either by a MABS adviser or by a panel personal insolvency practitioner (PIP) or panel accountant. Where a legal issue is identified, or where the borrower is facing repossession proceedings, they can also avail of free legal advice and assistance by a panel solicitor. The Scheme is to last 3 years with reviews every 6 months. • The National Asset Management Agency (NAMA) looks set to achieve its targets. As of June 2016, it had generated EUR 35.2 billion from the sale of commercial real estate loans/property and debtors refinancing their debt, and is expected to achieve a surplus of around EUR 2 billion by the time it winds-down. It has	distressed SMEs and residual commercial real-estate loans are sustainable by further assessing banks' performance against own targets. • Take the necessary steps to ensure that a central credit registry is operational by 2016.

information campaign on the support available to debtors in arrears.		redeemed EUR 25.6 billion or 85% of the EUR 30.2 billion of its senior debt.	

ANNEX 2

Debt sustainability analysis

Graph A2.1: **Gross government debt projections**



(1) The baseline scenario assumes no-policy change from 2017 onward, with a structural primary balance kept constant at last forecast year (cyclical effects until closure of output gap estimated using standard budgetary semi-elasticity). Costs of ageing are included.
(2) The SGP scenario assumes a structural adjustment path in compliance with the fiscal effort recommended by the Council until the excessive deficit is corrected, and thereafter an annual structural consolidation effort of 0.6 percentage points until the medium-term objective (MTO) is reached.
(3) The sensitivity tests on real GDP growth consist of enhanced (permanent) negative and positive shocks (-1 standard deviation/+1 standard deviation for the first 2 projection years, followed by a -0.5 percentage point (p.p.)/+0.5 p.p. over the remaining projection period) on real GDP growth applied from the year following the one of last actual data available until the end of the projection horizon (2026). The shock is symmetrically applied to actual and potential GDP growth, so that the output gap remains unchanged. The cyclical component of the balance is therefore not affected by these shocks to growth.
(4) The strong contribution of stock flow adjustment to debt in 2014 is mainly due to the liquidation of the Irish Banking Resolution Corporation (IBRC), which from 2015 should no longer have a significant impact on debt reduction.
Source: European Commission

Although debt to GDP ratio has fallen the high debt still remains a major source of vulnerability ([61])**.** The recent upward revision of GDP reduced the debt-to-GDP ratio in 2015 to 78.8%, about 15 pps. less than estimated in the spring forecast. Not accounting for the GDP revision, the public debt ratio fell by approximately 14 pps. from 2014, largely due to the surge in nominal GDP, the sales of state assets ([62]) and sizeable primary surpluses, coupled with a low interest environment. The Commission spring 2016 forecast projects the debt-to-GDP ratio to fall by about 7 pps. between 2015 and 2017, contingent on still robust GDP growth and the realisation of primary budget surpluses in the order of 2% of GDP in 2016 and 2017 each year. The previously announced disposal of stakes in government-owned banks has been delayed but would reduce the absolute level of public debt. The value of government holdings in the banks is estimated at around 8% of GDP.

Debt sustainability has improved since the fourth PPS review but full implementation of the SGP would ensure a clearer downward debt trajectory. The Commission's latest Debt Sustainability Analysis (DSA) based on the spring 2016 forecast shows that, if fiscal policy beyond 2017 were to remain unchanged to the last forecast year (2017), the general government debt-to-GDP ratio would steadily fall until 2024 to around 73.5% and slightly rise again thereafter mainly on account of increasing costs of ageing (Graph A2.1). The full implementation of the stability programme would nonetheless put debt on a firmly decreasing path, reaching the 43.6% of GDP reference value in 2026 ([63]).

Conversely, the sustainability of government debt remains vulnerable to negative economic growth shocks. Ireland's still high level of public debt makes government debt projections very sensitive to variations in economic growth and to the expected size of budgetary adjustment. According to the Commission's debt sustainability analysis, an enhanced negative shock to nominal GDP growth of 0.5 pps. would increase the public debt-to-GDP ratio by about 8.6 pps. to 83.2% by 2026 ([64]). On the other hand, save for any potential future changes to market conditions, interest rate risk for the Irish sovereign is low due to prudent debt management and low future refinancing needs ([65]). Ireland's government debt is largely long-term and its long maturity profile reduces risks from interest rate and market access shocks and eases debt financing ([66]). Finally, if fiscal policy were to revert back to its historical behaviour ([67]) the Irish debt ratio in 2026 would be as much as 20 pps. higher than under baseline no-fiscal policy change.

([61]) The DSA does not include information relating to the UK referendum on EU membership on 23 June 2016 or the substantial revision to 2015 national accounts announced by the CSO on 13 July 2016.

([62]) These include the cancellation of EUR 2.0 billion (0.5 % of GDP) of the floating rate bonds purchased from the Central Bank of Ireland, about EUR 0.5 billion (0.3 % of GDP) from the sale of contingent capital notes and equity in Permanent TSB, the partial redemption of the AIB's 2009 Preference Shares which resulted in the repayment of EUR 1.7 billion (0.9% of GDP) of capital to the State, and the transfer of EUR 1.6 billion (0.9 % of GDP) of Bank of Ireland's redeemed preference shares from the Ireland Strategic Investment Fund to the Exchequer. In 2016, the expected receipts from the redemption of the AIB's contingent convertible capital notes of EUR 1.6 billion (0.8 % of GDP) will contribute to the decline in gross debt.

([63]) The Stability Programme is built under a no-policy-change assumption according to which tax revenues are assumed to increase in line with nominal GDP growth while government primary expenditures are kept broadly constant in level terms. The assumption of broadly stable expenditure in level terms contrasts with both pre-crisis trends and the government's own estimates presented in the last expenditure review.

([64]) The enhanced shock is based on a decrease/increase of real GDP growth by one standard deviation, calculated over the last three years of historical data, for two years from the year following the one of last historical data available. After two projection years, the usual -0.5/+0.5 pps. permanent shocks on GDP growth is applied until the end of the projections period.

([65]) The average effective interest rate on government debt was estimated to be around 3.3 % in 2015, 0.2 pps. lower than in the previous year. This reflects the combination of currently very favourable market conditions and sensible debt management operations.

([66]) At about 13 years, the average maturity of public debt in Ireland is one of the longest in the EU.

([67]) That is, if the structural primary balance gradually reverts to the historical average of the last 15-year (deficit of 1.2% of GDP).

Table A2.1: **Sustainability indicators (in % GDP)**

	Ireland		
	No-policy-change scenario	**Previous PPS review (Autumn 2015)**	**SP scenario**
S2*	**0.5**	**1.3**	**-4.5**
of which:			
Initial budgetary position (IBP)	-1.3	-0.5	-5.3
Long-term cost of ageing (CoA)	1.9	1.9	0.8
of which:			
pensions	1.0	1.0	0.1
healthcare	1.0	1.0	0.8
long-term care	0.7	0.7	0.7
others	-0.8	-0.8	-0.9
S1**	**1.5**	**2.7**	**-5.1**
of which:			
Initial budgetary position (IBP)	-1.8	-1.6	-6.8
Cost of delaying adjustment	-	0.4	-
Debt requirement (DR)	2.0	3.1	1.0
Long-term cost of ageing (CoA)	1.3	1.3	0.7
S0 (risk for fiscal stress)***	0.4	:	
Fiscal subindex	0.3	:	
Financial-competitiveness subindex	0.5	:	
Debt as % of GDP (2015)		93.8	
Age-related expenditure as % of GDP (2015)		21.6	

Note: the 'no-policy-change' scenario depicts the sustainability gap under the assumption that the structural primary balance
* The long-term sustainability gap (S2) indicator shows the immediate and permanent adjustment required to satisfy an inter-temporal budgetary constraint, including the costs of ageing. The S2 indicator has two components: i) the initial budgetary position (IBP) which gives the gap to the debt stabilising primary balance; and ii) the additional adjustment required due to the costs of ageing. The main assumption used in the derivation of S2 is that in an infinite horizon, the growth in the debt ratio is bounded by the interest rate differential (i.e. the difference between the nominal interest and the real growth rates); thereby not necessarily implying that the debt ratio will fall below the EU Treaty 60% debt threshold. The following thresholds for the S2 indicator were used: (i) if the value of S2 is lower than 2, the country is assigned low risk; (ii) if it is between 2 and 6, it is assigned medium risk; and, (iii) if it is greater than 6, it is assigned high risk.
** The medium-term sustainability gap (S1) indicator shows the upfront adjustment effort required, in terms of a steady adjustment in the structural primary balance to be introduced over the five years after the forecast horizon, and then sustained, to bring debt ratios to 60% of GDP in 2030, including financing for any additional expenditure until the target date, arising from an ageing population. The following thresholds were used to assess the scale of the sustainability challenge: (i) if the S1 value is less than zero, the country is assigned low risk; (ii) if a structural adjustment in the primary balance of up to 0.5 pps. of GDP per year for five years after the last year covered by the spring 2016 forecast (year 2017) is required (indicating an cumulated adjustment of 2.5 pps.), it is assigned medium risk; and, (iii) if it is greater than 2.5 (meaning a structural adjustment of more than 0.5 pps. of GDP per year is necessary), it is assigned high risk.
*** The S0 indicator reflects up to date evidence on the role played by fiscal and financial-competitiveness variables in creating potential fiscal risks. It should be stressed that the methodology for the S0 indicator is fundamentally different from the S1 and S2 indicators. S0 is not a quantification of the required fiscal adjustment effort like the S1 and S2 indicators, but a composite indicator which estimates the extent to which there might be a risk for fiscal stress in the short-term. The critical threshold for the overall S0 indicator is 0.43. For the fiscal and the financial-competitiveness sub-indexes, thresholds are respectively at 0.35 and 0.45.

Source: European Commission, 2016 stability/convergence programme.

ANNEX 3

Supplementary tables

Table A3.1: **Fiscal accounts (based on 2016 spring forecast)**

	2010	2011	2012	2013	2014	2015	2016	2017
				% of GDP				
Indirect taxes	10.9	10.2	10.5	10.7	11.2	10.5	10.3	10.3
Direct taxes	11.8	12.0	12.8	12.8	13.2	13.0	12.4	12.3
Social contributions	5.7	5.7	5.5	5.7	5.8	5.3	5.1	5.0
Sales	3.2	3.0	2.8	2.5	2.5	2.4	2.2	2.1
Other current revenue	1.5	1.6	1.9	1.9	1.7	1.3	1.1	0.9
Total current revenue	**33.0**	**32.5**	**33.5**	**33.7**	**34.4**	**32.5**	**31.1**	**30.6**
Capital transfers received	0.3	0.5	0.3	0.3	0.4	0.3	0.2	0.2
Total revenue	**33.3**	**33.0**	**33.8**	**34.0**	**34.8**	**32.8**	**31.3**	**30.8**
Compensation of employees	11.6	11.0	10.8	10.4	9.9	9.1	8.7	8.6
Intermediate consumption	5.4	4.9	4.7	4.6	4.6	4.3	4.2	4.2
Social transfers in kind via market producers	3.0	2.9	3.0	2.8	2.7	2.4	2.2	2.1
Social transfers other than in kind	14.3	13.7	13.8	13.1	12.1	10.7	10.0	9.6
Interest paid	3.0	3.4	4.1	4.3	4.0	3.1	2.8	2.7
Subsidies	1.1	1.0	1.1	1.0	1.0	0.9	0.9	0.9
Other current expenditure	1.6	1.5	1.4	1.6	1.4	1.2	1.2	1.1
Total current expenditure	**40.0**	**38.4**	**38.9**	**37.7**	**35.8**	**31.7**	**30.1**	**29.2**
Gross fixed capital formation	3.3	2.4	2.0	1.8	2.1	1.8	1.8	1.8
Other capital expenditure	22.3	4.8	0.9	0.1	0.6	1.7	0.5	0.5
Total expenditure	**65.7**	**45.5**	**41.8**	**39.7**	**38.6**	**35.1**	**32.5**	**31.5**
	37.0	35.0	34.8	33.4	31.9	28.5	27.3	26.5
General government balance	**-32.3**	**-12.6**	**-8.0**	**-5.7**	**-3.8**	**-2.3**	**-1.1**	**-0.6**
Underlying government balance (EDP)	**-11.0**	**-8.5**	**-7.9**	**-5.7**	**-3.8**	**-1.3**	**-1.1**	**-0.6**
				EUR billion				
Indirect taxes	18.1	17.8	18.3	19.3	21.2	22.5	23.6	24.7
Direct taxes	19.6	20.8	22.3	22.9	24.9	27.9	28.3	29.5
Social contributions	9.5	10.0	9.7	10.3	10.9	11.4	11.7	12.0
Sales	5.3	5.2	4.9	4.6	4.7	5.2	5.1	5.1
Other current revenue	2.4	2.7	3.3	3.4	3.2	2.9	2.5	2.2
Total current revenue	**54.8**	**56.5**	**58.5**	**60.5**	**64.9**	**69.8**	**71.2**	**73.6**
Capital transfers received	0.6	0.9	0.6	0.6	0.8	0.7	0.6	0.6
Total revenue	**55.4**	**57.3**	**59.1**	**61.0**	**65.7**	**70.5**	**71.8**	**74.2**
Compensation of employees	19.3	19.2	18.9	18.7	18.8	19.5	19.9	20.6
Intermediate consumption	9.0	8.6	8.2	8.2	8.8	9.3	9.7	10.1
Social transfers in kind via market producers	5.0	5.0	5.2	5.0	5.2	5.1	5.1	5.2
Social transfers other than in kind	23.8	23.8	24.2	23.5	22.9	22.9	22.9	23.1
Interest paid	4.9	5.9	7.2	7.7	7.5	6.7	6.5	6.6
Subsidies	1.8	1.7	1.9	1.8	1.9	1.8	2.0	2.1
Other current expenditure	2.7	2.5	2.4	2.8	2.7	2.5	2.8	2.7
Total current expenditure	**66.5**	**66.7**	**68.0**	**67.7**	**67.7**	**68.0**	**69.0**	**70.3**
Gross fixed capital formation	5.6	4.1	3.6	3.3	4.0	3.9	4.2	4.4
Other capital expenditure	37.0	8.3	1.5	0.3	1.2	3.6	1.2	1.1
Total expenditure	**109.1**	**79.2**	**73.1**	**71.2**	**72.9**	**75.4**	**74.4**	**75.8**
General government balance	**-53.7**	**-21.8**	**-14.0**	**-10.2**	**-7.2**	**-4.9**	**-2.6**	**-1.6**
Deficit-increasing financial sector measures	35.4	7.1	0.3	0.0	0.0	2.1	0.0	0.0
Underlying government balance (EDP)	**-18.3**	**-14.7**	**-13.7**	**-10.2**	**-7.2**	**-2.8**	**-2.6**	**-1.6**

Source: European Commission

Table A3.2: **General Government debt projections (based on 2016 spring forecast)**

	2010	2011	2012	2013	2014	2015	2016	2017
Government deficit (% of GDP)	**-32.3**	**-12.6**	**-8.0**	**-5.7**	**-3.8**	**-2.3**	**-1.1**	**-0.6**
Government gross debt (% of GDP)	86.8	109.1	120.1	120.0	107.5	93.8	89.1	86.6
			levels, EUR billion					
Government deficit	**-53.7**	**-21.8**	**-14.0**	**-10.2**	**-7.2**	**-4.9**	**-2.6**	**-1.6**
Gross debt	144.2	189.7	210.0	215.3	203.3	201.3	204.2	208.4
Change in gross debt	39.6	45.5	20.3	5.3	-12.0	-2.0	3.0	4.1
Nominal GDP	166.2	173.9	174.8	179.4	189.0	214.6	229.2	240.6
Real GDP	166.2	170.5	170.7	173.2	182.2	196.4	206.0	213.5
Real GDP growth (% change)	**0.4**	**2.6**	**0.2**	**1.4**	**5.2**	**7.8**	**4.9**	**3.7**
Change in gross debt (% of GDP)	23.8	26.1	11.6	3.0	-6.3	-0.9	1.3	1.7
Stock-flow adjustments (% of GDP)	-8.5	13.6	3.6	-2.7	-10.2	-3.2	0.2	1.1
			% of GDP					
Gross debt ratio	**86.8**	**109.1**	**120.1**	**120.0**	**107.5**	**93.8**	**89.1**	**86.6**
Change in gross debt ratio	25.0	22.3	11.0	-0.1	-12.4	-13.8	-4.7	-2.5
			Contribution to change in gross debt					
Primary balance	-29.3	-9.2	-3.9	-1.4	0.2	0.8	1.7	2.1
"Snow-ball" effect	4.2	-0.5	3.5	1.2	-2.1	-9.3	-3.1	-1.4
of which								
Interest expenditure	*3.0*	*3.4*	*4.1*	*4.3*	*4.0*	*3.1*	*2.8*	*2.7*
Real growth effect	*-0.3*	*-2.1*	*-0.2*	*-1.7*	*-5.9*	*-7.4*	*-4.3*	*-3.1*
Inflation effect	*1.5*	*-1.7*	*-0.4*	*-1.4*	*-0.2*	*-5.0*	*-1.6*	*-1.0*
Stock-flow adjustments	**-8.5**	**13.6**	**3.6**	**-2.7**	**-10.2**	**-3.2**	**0.2**	**1.1**
Implicit interest rate	*4.7*	*4.1*	*3.8*	*3.7*	*3.5*	*3.3*	*3.2*	*3.2*

Source: European Commission

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