Ireland: Staff Concluding Statement of the 2016 Article IV Consultation and Fifth Post-Program Monitoring

June 24, 2016

Strong outlook and downside external risks

1. Ireland's economic outlook remains strong but vulnerable to external shocks. Growth is set to reach 5 percent in 2016 and expected to converge to its medium-term potential of about 3 percent thereafter. Domestic demand is projected to remain the main driver with robust private consumption on the back of continuously improving labor market conditions and vibrant investment activity. However, risks—largely external—are tilted to the downside. In particular, the vote in the UK to leave the EU, if accompanied by a marked slowdown in the UK and in the rest of Europe and a surge in financial market volatility, would have a significant adverse effect on Ireland in light of the strong trade and financial linkages with the British economy.

Attaining sustainable public finances

2. The government's plan to address social needs while ensuring sound public finances and a durable debt reduction is commendable. Ireland has established a remarkable track record of fiscal rectitude and exited the Excessive Deficit Procedure in 2015. Despite some health spending overruns, the budget deficit is projected to narrow to less than one percent of GDP in 2016 due to strong revenue performance. Windfall revenues should be saved to reduce the public debt further, thereby helping rebuild room for fiscal policy maneuver. The newly released Summer Economic Statement allocates the fiscal space available under the EU's Stability and Growth Pact rules to further expenditure increases and tax cuts from 2017 onwards, and also to a rainy-day fund from 2019. Under these policies, the medium-term objective (MTO) of a structural budget deficit of 0.5 percent of GDP in 2018 appears broadly achievable. Going forward, the government's intent to outperform the MTO is appropriate in light of the need to build adequate fiscal buffers to deal with potential negative shocks. This would also prevent additional fiscal stimulus when economic activity is projected to remain above potential and allow general government debt to decline significantly.

3. Fiscal policy can be more supportive of job-rich growth. Priority should be given to rebalance the tax mix and broaden the tax base, while improving spending efficiency and addressing infrastructure needs.

- *Rebalancing the tax mix would boost sustainable revenues and support job creation.* Less reliance on distortionary direct taxes, including by merging the universal social charge into a broader income tax with lower rates for below-median wage earners, would help reduce the tax burden on middle-income households, foster female labor force participation, and avoid welfare-traps for low-skilled workers. Implementation of a uniform VAT rate and faster scaling up of the property tax would compensate for lower revenues from direct taxes. Regressivity arising from these changes could be assuaged by means-tested transfers to low-income households
- *Enhancing spending efficiency would improve delivery of public services*. In this regard, persevering with the ongoing health sector reform—strengthening of primary care, reform of hospital budgeting, more extensive use of generic drugs—is thus important. This would also help generate resources needed to mitigate ageing-related spending pressures. Better

targeting of social transfers would contribute to improved inter-generational fairness for the young.

- *Increasing capital expenditure would buttress Ireland's competitiveness and support the population's well-being.* The prolonged retrenchment in public investment has taken a toll on the quality and adequacy of infrastructure. Public capital expenditure should thus be scaled up and prioritized to improve core infrastructure and technology, thereby strengthening Ireland's leading edge in the global market for high-value added products.

Achieving sustainable growth and increasing inclusiveness

4. Making Irish-owned firms more dynamic and productive would foster robust and sustainable growth over the long term. Total factor productivity growth has been lackluster in recent years, with differences between domestic firms and Irish affiliates of multinationals. Domestic small and medium-sized enterprises lag behind, reflecting limited access to finance, low innovation activity, and weak financial soundness. Policies should therefore focus on broadening financing options for firms, and increasing direct public sector support of their innovation activities, including through closer partnerships with education institutions. A more proactive approach to debt restructuring for distressed but viable firms would also support higher productivity.

5. Addressing structural impediments would strengthen job creation and make growth more inclusive. While the labor force is well educated, skill mismatches are relatively high in some segments. In addition, youth and long-term unemployment rates remain elevated, the latter particularly among adults with lower educational attainment. Enhancing labor activation policies and expanding technical and vocational programs would help retool skills and increase the likelihood of finding employment. Furthermore, female labor force participation is among the lowest in the EU. Policies to address the high cost of child care and its variable quality, and reduce high marginal income tax rates on second earners would strengthen incentives for women to enter the labor market.

Macro-financial policies: Tackling crisis legacies and mitigating boom-bust cycles

6. This year's consultation coincided with an in-depth assessment of the Irish financial sector under the IMF's Financial Sector Assessment Program (FSAP). Key findings include:

- Ireland's financial regulatory framework has been much strengthened since the crisis. The Single Supervisory Mechanism (SSM) in which the ECB is responsible for direct supervision of the significant institutions that make up the bulk of the Irish banking system, is working well. As experience is gained with the SSM, further streamlining and harmonization of certain processes will further increase its effectiveness.
- The financial soundness of banks, households, and corporates has improved in recent years. However, sensitivity analyses under the FSAP's adverse macroeconomic scenario point to vulnerabilities amplified by crisis legacies, which need to be addressed.
- Irish insurers have prepared for the introduction of Solvency II regulations which are now in force, but vigilance is needed against emerging risks. In securities market oversight, the Central Bank of Ireland is a leader in the analysis of collective investment vehicles' activities. The funds management industry in Ireland is now of global scale, with significant cross-border connections but only limited links to domestic banks. While the funds hold comfortable liquid buffers, enhanced monitoring and closing data gaps remain important. The Central Bank has also taken initiatives to address cyber risks.
- The credit union sector is undergoing an intense restructuring process with the Central Bank monitoring and intervening to support this as an important step to putting the sector on a sounder footing.

7. Recovery in the banking system is forging ahead, yet challenges persist. Banks' pre-provision profitability, albeit increasing, remains modest and prospects for further improvement are clouded by several factors, including continued deleveraging, prevalence of low-yield tracker mortgages, and unresolved distressed loans. In the current low-interest environment, supervisors need to be even more vigilant to ensure that profit seeking is supported by appropriate risk management. Mortgage lending rates should adequately reflect market conditions, legacy burden, and credit risk, including difficulties in realizing collateral. Disposal of the government's stakes in the banking system should continue. This would further reduce public debt.

8. The resilience of the non-financial private sector to shocks needs to be bolstered further. Household indebtedness is still high by international standards. The share of distressed loans–although declining–remains elevated, particularly mortgages in prolonged arrears. Intensified efforts should continue to resolve these loans, supported by the legal process, to incentivize

cooperation between borrowers and lenders. Further restructuring of distressed loans to the most vulnerable, but viable, firms would support a durable expansion of economic activity and reduce corporate sector's vulnerabilities. Continued care is needed to ensure that provisions remain adequate.

9. A potential buildup of new imbalances in the property market needs to be prevented. The introduction of macroprudential measures on mortgage lending appears to have mitigated pressures in the residential property market by curbing expectations of further price appreciation. These measures should be maintained as a permanent feature of the mortgage market to safeguard the resilience of banks and households against shocks. The Central Bank's intent to periodically assess the impact and effectiveness of these measures is welcome. Once the Central Credit Register becomes operational, the loan-to-income limit should be replaced with a debt-to-income limit, which better captures borrowers' repayment capacity. As housing supply remains constrained, additional policy actions should help expedite new construction. Demand pressures in the commercial real estate market need to be closely monitored and policy tools activated if risks to financial stability emerge.

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The mission thanks the authorities for the open and productive discussions and warm hospitality.