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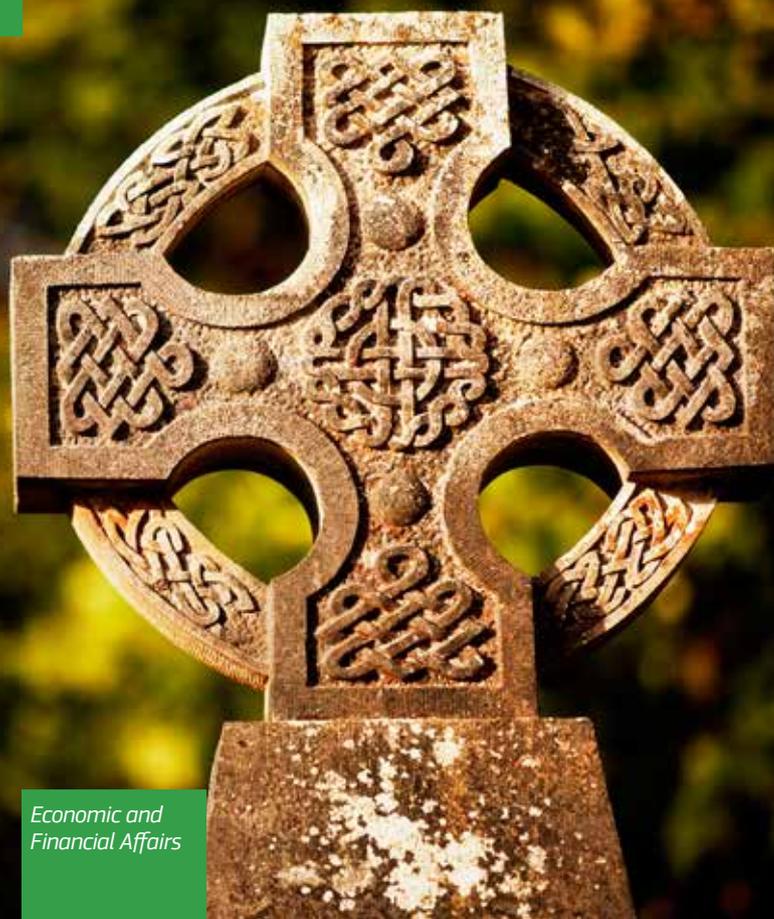
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Ex post Evaluation of the Economic Adjustment Programme

Ireland, 2010-2013

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European Commission

Directorate-General for Economic and Financial Affairs

Ex post Evaluation of the Economic Adjustment Programme

Ireland, 2010-2013

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ABBREVIATIONS

AIB - Allied Irish Banks

Anglo - Anglo Irish Bank

BOI - Bank of Ireland

BoP – Balance of Payment

BRRD - Bank Recovery and Resolution Directive

CBI – Central Bank of Ireland

CCPC- Competition and Consumer Protection Commission

CEBS - Committee of European Banking Supervisors

CER- Comprehensive Expenditure Review

CET 1 - Common Equity Tier 1

CID – Council Implementing Decision

CIFS - Credit Institutions Financial Support Scheme

CoCos - Contingent Convertible notes

CRO – Credit Review Office (Ireland)

CSO – Central Statists Office (Ireland)

DG ECFIN - Directorate General 'Economic and Financial Affairs' of the European Commission

DGS - Deposit Guarantee Schemes

DoF – Department of Finance (Ireland)

EA – Euro Area

EBA – European Banking Authority

EBS – EBS Building Society

EC – European Commission

ECB – European Central Bank

ECOFIN - Economic and Financial Affairs

EDP – Excessive Deficit Procedure

EFF – Extended Fund Facility

EFSF - European Financial Stability Facility

EFSM - European Financial Stabilisation Mechanism

EIB – European Investment Bank

ELA - Emergency Liquidity Assistance

ELG - Eligible Liabilities Guarantee Scheme

EPL - Employment Protection Legislation

ERO - Employment Regulation Order

ESA - European System of Accounts

ESM - European Stability Mechanism

ESRB - European Systemic Risk Board

ETB - Education and Training Board

EU – European Union

EWG - Eurogroup Working Group

FDI - Foreign Direct Investment

FET – Further Education and Training

GDP – Gross Domestic Product

GGD – Gross Government Debt

GNI – Gross National Income

HH - Household

HICP - Harmonised Index of Consumer Prices

IBRC - Irish Bank Resolution Corporation

IFAC - Independent Fiscal Advisory Council (Ireland)

ILP - Irish Life and Permanent

IMF – International Monetary Fund

INBS - Irish Nationwide Building Society

ISI - Insolvency Service of Ireland

ISIF - Ireland Strategic Investment Fund

LME - Liability Management Exercise

LTD - Loan-To-Deposit ratio

LTI - Loan-To-Income ratio

LTRO - Long-term refinancing operation

LTV - Loan-To-Value ratio

MIP – Macroeconomic Imbalance Procedure

MNC - Multi-National Company

MoU - Memorandum of Understanding on Specific Economic Policy Conditionality

NAMA - National Asset Management Agency (Ireland)

NFC – Non-Financial Corporation

NMW- National Minimum Wage

NPL - Non-Performing Loan

NPRF - National Pensions Reserve Fund

NRP - National Recovery Plan

NTMA - National Treasury Management Agency (Ireland)

OECD - Organisation for Economic Co-operation and Development

OMT - Outright Monetary Transactions

PCAR - Prudential Capital Assessment Review

PLAR - Prudential Liquidity Assessment Review

PMR - Product Market Regulation

PPS - Post-Programme Surveillance

PPSN - Personal Public Service Number

PRSI - Pay-Related Social Insurance

PTSB – Permanent TSB

REA- Registered Employment Agreement

REER – Real Effective Exchange Rate

RULC - Real Unit Labour Costs

SBCI - Strategic Banking Corporation of Ireland

SGP - Stability and Growth Pact

SME - Small and Medium-sized Enterprise

SMP - Securities Markets Programme

SRM - Single Resolution Mechanism

SSM - Single Supervisory Mechanism

SVR - Standard Variable Rate

TFP – Total Factor Productivity

ULC – Unit Labour Costs

VAT – Value Added Tax

VEC - Vocational Education Centre

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EXECUTIVE SUMMARY

This document presents an ex post evaluation of the three year EU/IMF financial assistance programme that Ireland completed in December 2013. The Irish programme was the second euro area (EA) assistance programme, and the first financed by two new financial assistance instruments established in 2010, the European Financial Stability Facility (EFSF) and the European Financial Stabilisation Mechanism (EFSM). It was designed to address the effects of the severe banking and fiscal crisis that had caused Ireland to lose market access, and cover Ireland's financing gap until market access was restored. The Irish programme was novel, complex, and economically and financially important for both Ireland and the EA as a whole. An ex post evaluation of the design, implementation and outcome of the programme is required by European Commission rules and in line with best practice. ⁽¹⁾ The aim is to draw lessons for the future from the programme as a whole.

In a global context of decreasing yields and risk premia, Irish economic growth from 2002 onwards was increasingly driven by a property bubble; the Irish banking sector overextended itself with the financial supervision and resolution frameworks proving to be inadequate. The property market crashed in 2007, exposing the vulnerability of the financial sector. The fiscal deficit exploded as cyclical revenues disappeared, and crisis-related spending pressures grew. These included significant financial support to Irish banks.

The Irish programme was put together in a climate of deep uncertainty in Ireland and the EA. The Irish authorities' initial response to the emerging financial and fiscal problems did not succeed in getting the situation under control. Developments elsewhere in the euro area also negatively impacted on the Irish situation. Continued uncertainty over the magnitude of the financial crisis, and the ability of the Irish sovereign to absorb its costs, drove sovereign bond spreads to record highs. At the same time, the EA crisis spread further across countries and sectors. On 21 November 2010, the Irish government requested external financial assistance.

Overall, the programme was relevant, appropriate and effective. Ireland regained market access and made significant progress on financial sector repair, fiscal consolidation and a return to sustainable growth. The financing provided under the programme enabled a smooth and sustained return to full market access for the Irish sovereign. The programme was effective in restoring creditors' confidence in the financial system, as confirmed by access to debt markets by the two pillar banks. Banking supervision improved significantly. The fiscal targets were realistic, and meeting them with a margin added to the credibility of the programme, including with respect to its effectiveness in breaking the vicious financial-sovereign loop that had proven so damaging to the Irish economy. Public debt is now on a downward path and fiscal governance has been strengthened. The Irish economy grew strongly in 2014 and is forecast to continue to expand. The current account balance has shifted into surplus, unemployment is falling, and cost-competitiveness has improved considerably. Nevertheless, challenges remain in fully addressing the legacy of the crisis. Long-term unemployment and youth joblessness remain at high levels and the risk remains that some cyclical unemployment becomes structural. The banking sector has been relatively slow to return to profitability. A high stock of public and private debt, including non-performing loans, continues to weigh on domestic demand. Structural reforms designed to make future growth more sustainable and inclusive are work in progress.

The €85 billion envelope agreed in December 2010 was appropriate: it proved sufficient to meet Ireland's financing needs until it regained market access at sustainable rates. At that time, it was right to include sizeable contingency reserves in the funding envelope in a context of high financial market volatility and uncertainty. The envelope, corresponding to approximately 50% of the Irish GDP, came from several sources. Nearly half were provided by the EFSM and EFSF. The remainder came from the IMF, bilateral loans, and Irish national funds. The funding envelope was consistent with the pace of fiscal adjustment envisaged, and was intended to ensure that Ireland would be able to roll-over

⁽¹⁾ Communication to the Commission (COM), 'Responding to Strategic Needs: Reinforcing the use of evaluation' (SEC(2007)213), http://ec.europa.eu/smart-regulation/evaluation/docs/eval_comm_sec_2007_213_en.pdf

maturing debt and provide support to its banking sector, even under adverse scenarios. Its size was also acceptable to the creditors. In 2011 and early 2012 Irish spreads remained high and volatile, but later in the programme Ireland was able to issue debt at sustainable interest rates.

Ireland received the full amount of external assistance, i.e. €67.5 billion, despite its financing needs proving lower than initially envisaged. Once market access had been sustainably restored and EFSF/EFSM terms were improved, explicit reassessment of whether the full financial envelope needed to be disbursed would have been warranted. Ireland's total gross financing needs proved to be €25 billion less than the programme envelope provided for, due mainly to lower bank rescue costs but also to lower cash deficits. The financial sector support was not ring-fenced in the programme envelope, thereby providing more funding to cover other financing needs and replenish the Treasury cash buffer. Ireland also benefited from the removal of the interest rate margins on the EFSF and EFSM loans and from substantial extensions of their maturities. This aided the sustainability of Ireland's debt and helped it to regain full market access, but did not trigger a discussion on adjusting the fiscal targets or the disbursements. With the removal of these margins, IMF loans became relatively expensive, which motivated Ireland's 2014 decision to repay IMF loans early.

The programme contained an appropriate and relevant set of measures to address Ireland's economic and fiscal challenges. The programme Memorandum of Understanding (MoU) built on the Irish authorities' own National Recovery Plan (NRP), which was itself finalised when discussions with the European Commission, ECB and IMF on economic adjustment were already underway. The fiscal and structural reform content of the two documents was largely in line, and built on actions already taken in the years since the crisis first hit. The top priority was rightly given to financial sector restructuring. Fiscal measures were necessary given the large fiscal deficit and growing debt. The structural reforms in the programme were appropriately limited, as Ireland is a relatively competitive and flexible economy. The programme was specified and monitored on the basis that the Irish authorities were willing and able to implement it effectively. Overall, this approach worked well and the programme was a success. Nevertheless, where programme implementation was less smooth, such as on reforms to increase competition in legal services, the capacity of the European Commission, ECB and IMF (hereinafter referred to as the three institutions) to step in and drive progress appears to have been mixed. In a context of strong overall ownership by the Irish authorities, a number of conditions were phrased in terms of "introducing" (in the sense of "submitting") rather than "adopting" legislation, but this did affect the capability of the programme process to drive the completion of structural reforms. Flexibility in programme conditions was appropriate when it reflected evolving circumstances and knowledge.

The financial sector measures were rightly focused on bank recapitalisation and restructuring, while being constrained by policies introduced since 2008, which had largely misinterpreted the crisis as being one of liquidity and confidence. When the programme started, the credit institutions Eligible Liabilities Guarantee (ELG) Scheme was covering more than half of the unsecured senior debt of the domestic banks. The National Asset Management Agency (NAMA) had recently been established and was buying up non-performing assets from domestic banks. NAMA's existing structure was maintained through the programme. The government had already injected €46 billion (including €31 billion of promissory notes) into domestic institutions. This included €34.7 billion into two of the five systemic banks, Anglo Irish Bank (Anglo) and Irish Nationwide Building Society (INBS), alone. This ever increasing support to banks had undermined the credibility in the capacity of the Irish authorities to solve the banking problems, including for financial markets. The remaining challenges included reducing the banks' reliance on emergency central bank funding, downsizing the financial sector, addressing the poor and unclear quality of banks' assets, and ultimately breaking the vicious bond between the health of the financial institutions and the sovereign.

In the specific context of Ireland in 2010, not bailing-in unguaranteed and unsecured senior creditors of domestic banks was appropriate and reflecting complex considerations. In theory, a bail-in is preferable insofar as it limits the costs for the State and encourages proper risk pricing. Bail-in

provisions are now enshrined in the new EU regime. However, a careful assessment concluded that the conditions for such a bail-in were not present in Ireland nor in the EU at the time. With no legal framework in place to manage such an exercise, the legal and economic risks were considered too great in light of the potential benefits. The risks of spill-overs to the Irish and EU financial systems were highly uncertain and perceived to be very high, especially given the absence of a proper EU bank resolution framework. The alternative of a burden sharing that only applied to the senior creditors of the institutions that were to be resolved, Anglo and INBS, would have had fewer benefits to the Irish Exchequer but would still have entailed considerable risks.

The large upfront recapitalisation of banks was appropriate and effective: it helped to restore confidence in the solvency of the Irish banks and sovereign in a context of high uncertainty. In 2011, aggregate recapitalisation needs were finally agreed at €24 billion, of which the State provided the majority (€16.6 billion). This was lower than the €35 billion (including contingency reserves) envisaged in the programme envelope, but higher than the 2011 Prudential Capital Assessment Review (PCAR) assessment of €18.7 billion. The spreads on the senior bonds of the two pillar banks, Allied Irish Banks (AIB) and Bank of Ireland (BOI), started reducing after summer 2011. The two banks regained unguaranteed market access in late 2012. Given that large up-front recapitalisation could have impaired banks' incentives to clean-up their balance-sheet, an earlier introduction of mortgage restructuring targets could have been envisaged.

Bank restructuring was overall appropriately designed: Anglo and INBS were resolved. Competition and fiscal concerns justified the decision not to resolve Permanent TSB (PTSB), despite doubts over its viability. Decisions on whether to resolve or restructure institutions were timely and consistent, which lent the programme credibility. The resolution of Anglo and INBS was envisaged from the start of the programme, and by the end of it the two banks had been successfully put into liquidation. Taken in isolation, there could have been a case for also resolving PTSB (the banking operations of Irish Life and Permanent) given concerns over its viability. However, this option was not pursued because it risked harming competition. Moreover, the immediate fiscal cost of resolution was higher than for restructuring. The restructuring plan for PTSB was approved in April 2015 by the European Commission under State aid rules; the bank is making progress, including raising additional private capital in 2015, although it is yet to reach profitability.

Banks have downsized their balance sheets and stabilised their funding structure, but deleveraging targets did not translate into a reduction in non-performing loans (NPLs). In line with the deleveraging targets, the banks reduced their balance sheet by around €70 billion (45% of GDP). Significant progress was also made in reducing the banks' reliance on the Eurosystem and improving their loan-to-deposit ratio. The deleveraging process was managed flexibly in order to minimise unintended consequences such as high deposit rates or an excessive squeeze on new lending. Disposals – which were in line with EU State aid rules, requiring burden sharing by the beneficiary of aid – may have been too focused on foreign assets as they left Irish banks with less profitable businesses, although this helped to avoid domestic fire sales. Reforms to financial sector governance were much needed but required preparation before they could be implemented. The new personal insolvency framework was put in place only in November 2013 and gained consensus support, but has subsequently suffered from low take-up. At the end of the programme, the envisaged introduction of a credit registry had not yet happened. Also, a decline in NPLs was yet to be seen.

Ireland's fiscal targets proved to be appropriate: they were realistic and were met with a margin, aided by the easing of EFSF/EFSM loan terms, although measurement issues could have been more clearly addressed. At the start of the programme Ireland's structural deficit was assessed to be in double-digits and public debt had increased sharply. The size of the deficit, and worsened economic outlook, justified the decision in December 2010 to move Ireland's deadline for correction of the excessive deficit back by one year to 2015. Ireland implemented sufficient reforms to meet the fiscal targets set out in the programme, whether defined bottom up (consolidation measures) or top down (fiscal deficit reduction),

and is on track to meet the Excessive Deficit Procedure deadline on current forecasts. Overachievement in meeting realistic fiscal plans helped to generate a virtuous circle of good news and credibility. The focus on expenditure reduction reflected the Irish government's preferences. Measuring the size of the fiscal adjustment has proven to be quite difficult. Bottom-up measurement points to a front-loaded consolidation within the programme period, following on from strong consolidation packages in the two years prior to the programme. In contrast, the change in the structural balance points to a back-loaded consolidation – although the structural balance presents substantial shortcomings as a measure of the policy response during times of strong economic change. Ireland's return to GDP growth and market access suggest the scale and profile of consolidation were broadly appropriate. The 2011 lowering of EFSF/EFSM interest rates represented a sizeable fiscal windfall. More consideration could have been given to adjusting the fiscal targets in response, thereby maintaining the originally planned consolidation efforts. Changes to broaden the tax base and control spending have made the public finances more stable and sustainable.

The reforms made to fiscal governance, which were appropriately included in the programme, should in principle support durable debt reduction and temper the risk of pro-cyclical fiscal policy choices. The fiscal governance reforms aimed to prevent a repeat of the overspending during the pre-crisis boom. The fiscal rules and medium-term budgetary framework, adopted under the Fiscal Responsibility Act in 2012 and its amendment in 2013, give Ireland one of the strongest fiscal governance frameworks in the EA in principle. The independent Irish Fiscal Advisory Council (IFAC) became operational on an interim basis in 2011 and was made permanent in 2012. Ireland's debt sustainability risks have eased, but public debt remains high. The fiscal framework will need to prove its worth if a strengthening economy generates growing pressure for a premature relaxation of fiscal policy.

The targeted structural reforms included in the programme were broadly appropriate but their implementation faced some political and technical challenges. The Irish authorities recognised that structural reforms were not the primary focus – particularly for the IMF and ECB. The labour market measures in the MoU were needed to address the risk of the long-term unemployment and skills mismatches generated by the boom-bust cycle becoming permanent. Product market and sectoral reforms aimed to tackle more long-standing economic inefficiencies. In one sense, the addition of skills and health sector measures during the programme was a positive sign of flexibility. But ideally these reforms would have been included and progressed as soon as possible given the challenges that implementing structural reforms present. In a few cases, Ireland's technical or political capacity to draft, pass or implement legislation proved to be a constraint. This could potentially have been anticipated and mitigated, for example by carving out priority aspects of complex "omnibus" bills for early implementation. Ireland showed good overall administrative capacity and did not need extensive technical assistance, but greater use of targeted support could have been beneficial, particularly for labour market and skills policies.

Broad based reforms to tackle both demand and supply side impediments to hiring have been relevant and appropriate but will take time to make an impact. The cost of employing workers at the minimum wage and in specific sectors was reduced, although the measures in the MoU were partly overtaken by political and legal developments. The new active labour market and skills systems that have been put in place, including Intreo, Education and Training Boards (ETBs) and SOLAS (the new Further Education and Training Authority), should help to raise the employment rate of young and lower-skilled workers over the medium term. Given that the need for these reforms was clear by 2010, slow progress in making the new institutions fully operational has raised the risk of hysteresis.

Progress on implementing regulatory reforms that affect vested interests has been mixed. Persistent spending overruns led to the inclusion of health sector reforms towards the end of the programme. It was only in late 2013 that the Irish authorities presented a Finance Operative Model and an eHealth strategy, with key milestones left for the post-programme period. Progress has been made in containing the cost of pharmaceuticals but potential further savings remain dependent on post-programme actions. In 2010, domestic water supplies were free at the point of use. The water network was fragmented and suffered

from under-investment, high leakage, variable water quality and occasional service disruptions. The introduction of a national water utility, Irish Water, and household water charges proved practically and politically challenging. Good progress was made in improving the economy-wide competition framework, although Ireland still lacks civil means of enforcing competition law. Reforms to increase competition in the legal services continue to experience excessive legislative delays. The programme may have missed an opportunity to deliver more fundamental reform to protected sectors.

The burden of adjustment was quite widely shared across Irish society and Ireland's social safety net continued to function effectively, though deprivation has risen. The programme avoided sharp across-the-board reductions in social support. As a result, the comprehensive social safety net that Ireland had in place prior to the programme remained intact. Though distributional considerations were an intrinsic part of programme discussions, the distributional impact of austerity measures was only periodically addressed in the programme reviews.

The programme was consistent with updated EU rules and initiatives and benefitted from them. Ireland's experience also informed the creation of the new EU/EA regulatory framework. Having lost market access, Ireland needed a financial assistance programme. European financial resources (EFSM/EFSF) had to be part of the programme to deliver a big enough funding envelope to re-assure the markets, prevent a full collapse of the Irish banking system and allow a staged fiscal adjustment. At the same time, ECB and European Council statements and actions at the EA level were also important in reassuring the markets of Ireland's solvency. The decision to reduce the interest rate on EFSM/EFSF loans to well below the cost of IMF funds aided Ireland's debt sustainability but makes the ESM (as the successor to the EFSF) a much more attractive lender than the IMF for any future programme. The MoU was consistent with broader EU policies, including the Stability and Growth Pact, rules on fiscal governance, and state aid requirements. The development of the EU surveillance framework over the programme period, including the so-called Six Pack and Two Pack, partly reflected failures in the pre-crisis system. In December 2013, Ireland entered into Post-Programme Surveillance (PPS), which will continue until 75% of the financial assistance has been paid back.

The following lessons can be drawn from this ex post evaluation of the Irish assistance programme:

Broader financial sector governance measures, including reforms to the insolvency framework, should be given a high priority. They contribute to the effectiveness of bank recapitalisation and restructuring. However, governance reforms tend to lose momentum when the immediate pressure eases. Prompt supervisory actions could help to achieve more upfront loan provisioning and restructuring, with the aim of accelerating balance sheet repair.

Ireland's problems informed the design of the new EU bank resolution framework, under which bail-in should be implemented upfront in future. This should limit the costs of banking sector support to the State in times of crisis and encourage proper risk pricing ex ante. The capital requirements for banks under restructuring should, in any case, reflect credible assumptions on the losses yet to be realised. These losses should, in turn, be promptly recognised.

In financial sectors dependant on wholesale and other unstable sources of financing, deleveraging is an important means to address the inherent risks in the funding structure and to improve its resilience. The deleveraging process is ultimately unavoidable and should take place as soon as possible. Nevertheless, it is important that the deleveraging process does not lead to fire sales, excessive competition for deposits among banks leading to hikes in deposit interest rates, or an undue squeeze on new lending.

Banking sector restructuring entails complex considerations about banks' viability, in a context of high uncertainty and potential spillovers. Nevertheless decisions on either resolution or restructuring should be followed by prompt and consistent actions to ensure a timely liquidation or return to viability.

Consolidation plans which are realistic and in line with a country's priorities can give strong impetus and confidence to the consolidation process. Achievable fiscal targets give the programme stability and credibility.

Achievable fiscal targets can lead to a virtuous circle of good news and credibility for the programme. Frontloaded fiscal consolidation allows the brunt of the impact to be introduced when the importance of adjustment is well understood and helps underpin a strong return of market confidence. Nevertheless, it needs to be done with due consideration of the implications for growth and unemployment. Care should be taken to be explicit in how the consolidation effort will be measured in a programme context. Measuring the effort made according to the impact of the measures may have strong merits, but is not without its own measurement issues. Being explicit about these measurement issues at the start of the programme can help add credibility to it.

Structural reforms needed to rebalance the economy should be included in the programme from the beginning. They then need to be worked up and resourced as soon as possible, given that their design and implementation takes time. Structural reforms can present significant technical and legislative challenges, and affect vested interests. Including necessary reforms in the programme increases the chances of them happening, but the sustained focus of the national authorities and the three institutions is needed to deliver timely and successful implementation. The possible need for technical assistance should be considered as part of the programme design process, or in early reviews. When structural reforms are complex and may be facing delays, the possibility of carving out priority aspects for early implementation should be considered.

In the presence of high financial market volatility and uncertainties about banks' capital needs, the inclusion of sizeable contingent reserves in the financial envelope adds to the credibility and effectiveness of the programme. Nevertheless, a faster-than-expected and apparently sustainable improvement in financial and economic conditions during the programme justifies a reassessment of the financing gap and the size of the associated disbursements. Ring-fencing the financial sector support in the total envelope would also be desirable, at a minimum to trigger an explicit reassessment of whether the full financial envelope needs to be disbursed.

A programme MoU should reflect all aspects of policy dialogue that are important for the success of programme, including the distributional impact of adjustment measures.

The contribution of programme conditions in reaching the programme's objectives should be constantly monitored. Programme requirements should remain flexible, with a view to adapting existing measures and adding new ones when required.

While it is known that economic crises and the subsequent adjustment can have high social costs, the distributional and social implications are generally difficult to estimate accurately at the start of a programme. However, distributional issues should be clearly and systematically addressed as part of the programme process and documentation.

Ownership by the authorities is key to programme success. A programme consistent with national preferences fosters ownership. Nevertheless, with due consideration to the degree of ownership and institutional capability of national authorities, programme commitments concerning complex reforms to address long-term problems should be more detailed, and closely monitored, especially when vested interests are strong.

The creation of a structured process for monitoring and enforcing programme reforms within the national administration is beneficial to a programme's success. It can have positive spillover effects on the efficiency and effectiveness of a national public administration.

1. INTRODUCTION

In December 2013, Ireland completed a three year joint European Union (EU) and International Monetary Fund (IMF) financial assistance programme, which had been set up in response to a severe banking and fiscal crisis.⁽²⁾ The programme provided €85 billion in assistance from EU, IMF and Irish sources. Meanwhile, the European Central Bank (ECB) provided liquidity support for the Irish banking system. The assistance allowed Ireland to cover its financing needs at a time when the fall-out from the economic and financial crisis had severed the country's access to financial markets. The bursting of the real estate market bubble had placed the financial system under unsustainable pressure and wrought havoc on the public finances.

The provision of financial assistance was conditional on Ireland implementing policy reforms that were set out in a Memorandum of Understanding on Specific Economic Policy Conditionality (MoU) accompanying the Memorandum of Economic and Financial Policies. The programme helped buffer the unwinding of unsustainable economic imbalances which had built up during the preceding boom, while appropriate policy reforms were introduced. The programme's primary objective was to restore financial market confidence by stabilising the banking sector and strengthening the public finances, while containing the negative spillover effect to other euro area countries.

The economic adjustment programme for Ireland was the first financial assistance programme⁽³⁾ in a euro area country to be completed, with the country returning to the financial markets. The assistance was granted from two mechanisms – the European Financial Stability Facility (EFSF) and the European Financial Stabilisation Mechanism (EFSM) – that had just been set up in response to the crisis, as there was no mechanism to support euro area countries prior to 2010. The completion of the Irish programme serves as the first opportunity to take an in-depth and comprehensive look at how a euro area financial assistance programme was delivered.

This document presents an ex post economic evaluation of the programme design, implementation and outcomes. Its purpose is to assess the financial adjustment programme in order to draw lessons to inform the policy debate and improve future policy-making, when designing and implementing financial adjustment programmes, whether in the euro area or elsewhere. To do so, it looks at how the design and implementation of the programme have contributed to the evolution of the Irish economy and the attainment of the programme's objectives. The approach is qualitative in the sense that the conclusions are based on economic judgement rather than on an econometric model. This is because it is not possible to construct a credible counterfactual at a time of such changing economic conditions in both Ireland and its partners. In addition, the qualitative approach allows the impact of aspects of the programme which cannot be quantified but may nevertheless be important – such as the political context – to be considered. Details of the methodology used in producing the evaluation are included at Annex 1.

This evaluation is in response to the European Commission's requirement to evaluate the impact of its policies.⁽⁴⁾ The Commission's internal working arrangements, as well as those in relation to the IMF and the ECB fall outside its scope, as do the actions of the Irish authorities prior to the programme. A particular focus is given to the particular contribution of the EU and the European context of the programme. In line with international good practice, particular care was taken to create an institutional

⁽²⁾ Ireland formally requested financial assistance on 21 November 2010. The economic adjustment programme for Ireland was negotiated in late November 2010 and formally adopted by the Eurogroup/ECOFIN Council on 7 December 2010, http://www.eurozone.europa.eu/media/303953/st17211-re01.en10_decision_ie.pdf.

⁽³⁾ The other euro area countries that been granted financial assistance are Greece, Portugal, Spain and Cyprus. In the case of Spain, the assistance was granted only to provide support for the financial sector. Spain completed its programme shortly after Ireland and Portugal's programme ended in June 2014. In the case of Greece, the first assistance programme was followed up by a second one which is still underway at the time of writing of this report. The programme for Cyprus has an end-date of March 2016.

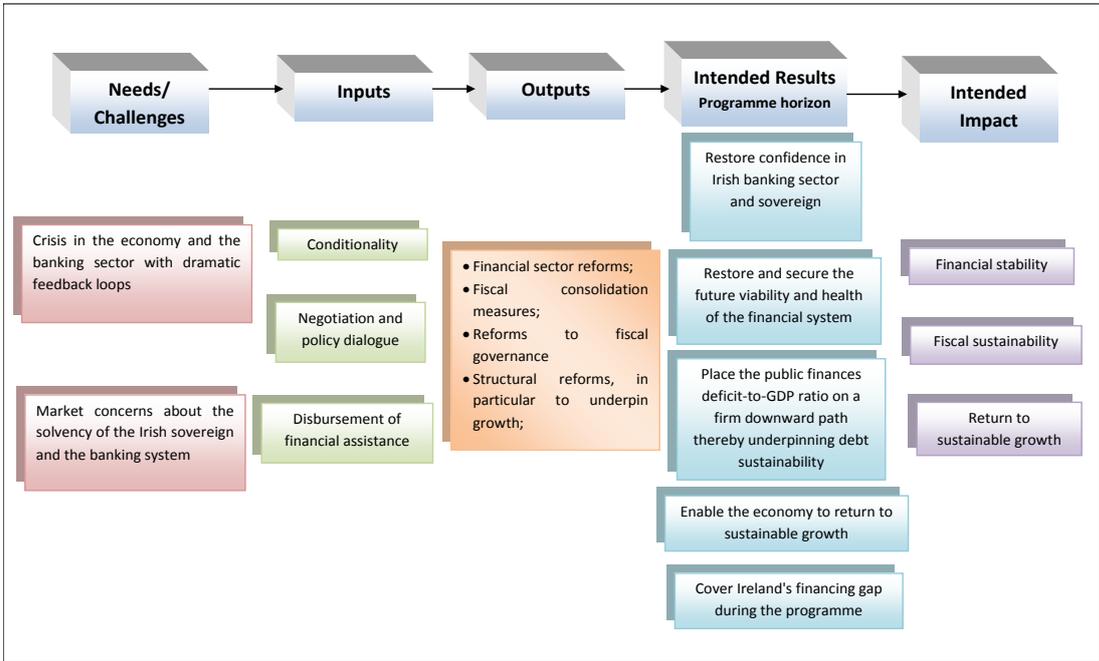
⁽⁴⁾ Evaluation standards are set out in the Communication to the Commission (COM), 'Responding to Strategic Needs: Reinforcing the use of evaluation' (SEC(2007)213), http://ec.europa.eu/smart-regulation/evaluation/docs/eval_comm_sec_2007_213_en.pdf.

separation between the evaluation and the implementation of the programme itself, to ensure the independence and impartiality of the exercise. Annex 1 provides more details on these arrangements.

Using the framework set out in the European Commission's evaluation standards, the evaluation considers the Irish economic adjustment programme under the structure set out in Figure 1, below. The relevance, appropriateness (efficiency) and effectiveness of the programme's inputs are assessed in terms of their contribution to the programme's intended results over the programme period and their longer term impact on the economy of Ireland. It is a performance rather than a compliance oriented exercise. The evaluation looks into the added value of the EU's involvement and the coherence of the programme with other EU policies. Annex 1 provides more details on this approach.

The remainder of the report is organised as follows. Section 2 gives a short overview of the roots of the crisis. Section 3 presents an overview of the programme and gives a broad assessment of its results, by also highlighting the EU/euro area context. Section 4 considers the size and terms of the financing envelope. Sections 5, 6, and 7 assess policy design and results for the financial sector, fiscal policy and governance, and structural reforms, respectively. Section 8 looks at the performance of the Irish economy after the programme, in order to shed light on the remaining challenges. Finally, Section 9 concludes and discusses some broader lessons from the experience of the economic adjustment programme. The method and process followed for this ex post evaluation is described in Annex 1. The Irish authorities' views on the ex post evaluation are reported in Annex 2.

Intervention logic of Economic Adjustment Programme for Ireland 2010-2013

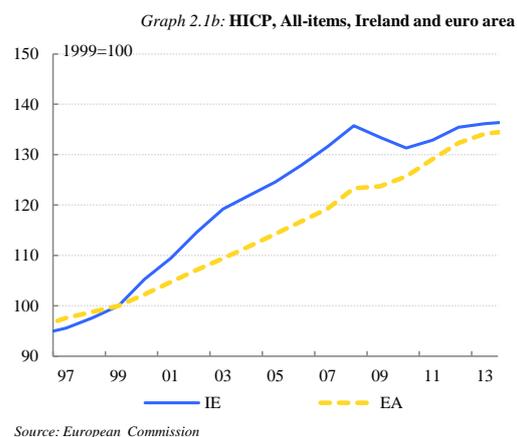
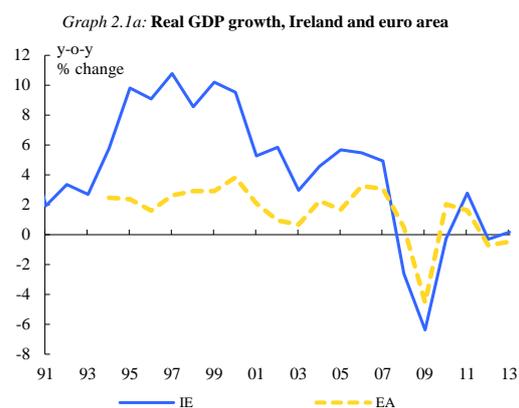


2. THE RUN-UP TO THE PROGRAMME: BOOM - BUBBLE - BUST

This section puts the Irish economic adjustment programme into perspective by highlighting the origins of the Irish financial and sovereign debt crisis. It sets out how a successful catching-up process, associated with fast Gross Domestic Product (GDP) expansion on the back of strong productivity and employment growth, turned into an unsustainable construction boom and property bubble. The main forces at work were rapid credit expansion, accelerating house-price inflation, rising consumer expenditure and pro-cyclical fiscal policies. Against the background of sharply reduced nominal and real interest rates and easy borrowing conditions, a self-reinforcing cycle was set in motion which raised private sector debt to unsustainable levels. Due to these home-grown vulnerabilities, Ireland was particularly ill-prepared to weather the global financial crisis that climaxed in the collapse of Lehman Brothers in September 2008. The Irish economy entered into deep recession in 2008. External funding, an important source of financing for Irish banks, dried up, while the asset side of banks' balance sheets was substantially impaired following the bursting of the property bubble. The break-down of the banks' risky funding model, and the continuing pile-up of non-performing loans, culminated in a fully-fledged banking crisis and eventually in a sovereign-debt crisis. Given the relatively high flexibility of the Irish economy, the adjustment of prices and employment started already in 2008. However, access to financial markets and fiscal sustainability continued to deteriorate until the Irish government had to pull the ripcord and request external financial assistance in November 2010.

2.1. HOW A SOUND ECONOMIC BOOM TURNED INTO A PERILOUS BUBBLE

From the mid-1990s until 2007, the Irish economy enjoyed strong economic growth. The underlying drivers of economic activity changed fundamentally after the turn of the millennium. Ireland recovered quickly from the downturn following the European exchange-rate crisis in 1992-93 and experienced a genuine boom until the early 2000s (see Graph 2.1a). Economic reforms, favourable demographics and rising educational attainment gave rise to a higher labour force participation rate and increasing labour productivity. The launch of the EU single market had a positive impact on foreign direct investment (FDI) and boosted Irish exports. Productivity growth in the tradable sector exceeded the EA average and spilled over to the non-tradable sector.



In the second half of the 1990s, nearly half of Ireland's national output growth was attributable to changes in total factor productivity (TFP).⁽⁵⁾ Irish living standards converged rapidly towards the EA average and Irish GDP per capita surpassed the EA (EA18) average in 1996. The growth paradigm of the Irish economy started to change following the sharp drop in real interest rates around the onset of the

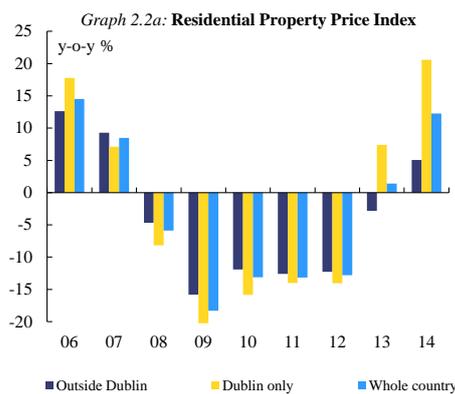
⁽⁵⁾ See National Competitiveness Council, Ireland's Productivity Performance, 1980-2011, April 2011.

introduction of the euro. From 2002 to 2007, the economy continued to exhibit high growth rates, but productivity growth slackened, while accelerating wage growth and rapidly rising property prices increased price pressures. As a consequence, consumer and producer prices rose much faster than in most other EA Member States (see Graph 2.1b) ⁽⁶⁾ and wage growth exceeded productivity gains by a large margin. The implied rise in unit labour costs gradually eroded price competitiveness. Ireland lost export market shares, imports grew rapidly and the current account balance turned into a deficit in 2005.

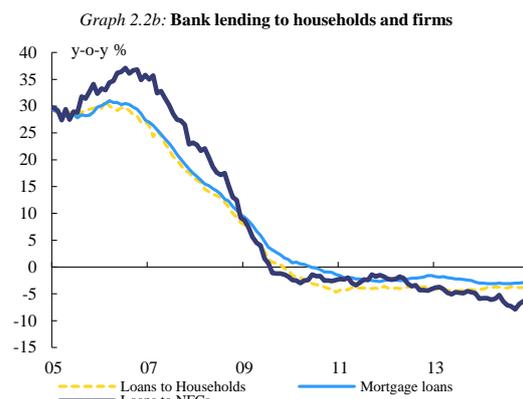
An unsustainable property boom...

A seemingly robust economic situation and very favourable financing conditions led banks, corporates and private households to engage in excessive risk-taking. In particular, low interest rates and lax credit standards (amid intense competition for business in an overheating economy and property market) boosted credit growth. According to data from the Central Bank of Ireland (CBI), the total assets of the domestic banking sector amounted to over €700 billion or 500% of GDP in 2010. ⁽⁷⁾ The banking sector was highly leveraged, as indicated by a loan-to-deposit (LTD) ratio of about 220% ⁽⁸⁾, and bank funding relied increasingly on international money market funds. The rapid credit expansion led to over-investment in real estate and accelerated consumer spending. As a result, the indebtedness of both households and non-financial corporations increased significantly, amplifying internal and external imbalances.

The high exposure to the property market made the Irish banking sector particularly vulnerable to potential sharp corrections in the housing market. The combined effects of rising policy rates, over-supply in the construction sector and uncertainty about the future tax treatment of property led to a slowdown in the housing market, starting in 2007. Exacerbated by the global financial crisis, this eventually turned into a housing bust with sharp falls in new housing construction, property transactions and house prices (see Graph 2.2a). By the end of 2010 house prices had declined by 37% from their peak in September 2007 and growth in bank lending to the private sector sharply decelerated and turned negative by 2009 (see Graph 2.2b). As a result, the banks suffered huge losses on their loans. At the same time, short term inter-bank lending, on which Irish banks had become heavily reliant, dried up with the intensification of the global financial crisis in autumn 2008.



Source: Central Statistics Office (CSO), Ireland



Source: Central Bank of Ireland

⁽⁶⁾ Member States which experienced similar property and construction bubbles, such as Spain, are noteworthy exceptions.
⁽⁷⁾ At the peak in 2008, total assets amounted to €63 billion.
⁽⁸⁾ See CBI database, Credit Institutions (Domestic Market Group) - Aggregate Balance Sheet, <http://www.centralbank.ie/polstats/stats/cmab/pages/money%20and%20banking.aspx>

...exacerbated by domestic policy errors...

Fiscal policy mistakes during the run-up to the crisis contributed to the subsequent challenges faced by the Irish government. Fiscal policy was strongly pro-cyclical and government spending rose rapidly in the pre-crisis years. At the same time, the composition of tax revenues shifted gradually from sources of taxation less sensitive to the business cycle, such as personal income tax, to more cyclical revenue sources, notably corporate tax, stamp duties and capital taxes. In particular, large VAT windfalls due to residential construction proved transitory and unsustainable. Moreover, tax policy helped fuel the already soaring property market. Before the crisis, Ireland had no annual recurring tax on residential property and interest payments on mortgages were tax-deductible. ⁽⁹⁾ Social transfers and the public sector wage bill increased substantially between 2000 and 2007. In early 2008, the earnings of public sector employees exceeded those of their private sector counterparts by 40%. ⁽¹⁰⁾ Social expenditure had doubled between 2000 and 2007, in part due to significant increases in pension payments and welfare benefits. Public investment surged: expenditure on gross fixed capital formation averaged almost 4% of GDP in 2000-2007, compared to an EU average of 3% of GDP.

Financial regulation and prudential supervision proved inadequate and failed to rein in exuberant credit growth and banks' ballooning balance sheets. The "light touch" regulatory approach was characterised by a lack of proper enforcement mechanisms and a non-intrusive style of supervision. ⁽¹¹⁾ This approach was motivated by the concern that stronger and more robust regulatory action would have adversely affected the competitiveness of credit institutions and made Ireland less attractive for international financial investment. Furthermore, concerns were voiced that a more aggressive use of regulatory tools could have been criticised as running contrary to the spirit of principles-based regulation. These shortcomings were further exacerbated by insufficient monitoring of macro-financial linkages due to inadequate cooperation between the central bank and the financial regulator. ⁽¹²⁾

... while early warning signals were ignored and external surveillance proved too lenient

In light of flawed domestic policies and inadequate national financial regulation, external surveillance might have sounded the alarm. But neither the IMF, the Organisation for Economic Co-operation and Development (OECD) nor the European Commission adequately identified key vulnerabilities, even though some external and domestic commentators were critical of the fiscal policy stance. ⁽¹³⁾ A synoptic view on IMF *Article IV consultation* staff reports suggests that vulnerabilities of the Irish economy, in particular those of its banking system, were regarded as being manageable. Likewise, the IMF's major Financial System Stability Assessment of 2006 failed to sound the alarm. ⁽¹⁴⁾ Although noting that debt levels had reached very high levels, the OECD asserted in April 2008 ⁽¹⁵⁾: "*The risks associated with the sharp run-up in domestic indebtedness have so far been contained. Irish banks are well-capitalised and profitable, so they should have considerable shock-absorbing capacity.*"

Prior to the global financial crisis and the EA sovereign debt crisis, the EU surveillance framework focused almost exclusively on fiscal policy under the provisions of the Stability and Growth Pact (SGP). As the framework required, other policy areas were only monitored to the extent that fiscal issues were concerned. Macro-financial linkages and the potentially detrimental effects of unsustainable private

⁽⁹⁾ See Regling, K. and M. Watson, A preliminary report on the sources of Ireland's banking crisis, *Reports of the Commission of Investigation into the Banking Sector in Ireland*, 2010, p. 26-7, <http://www.bankinquiry.gov.ie/>.

⁽¹⁰⁾ Data based on CSO survey on Earnings Hours and Employment Costs (EHECS).

⁽¹¹⁾ See Honohan, P., 'The Irish banking crisis: Regulatory and financial stability policy: 2003-2008'; A report to the Minister for Finance by the Governor of the Central bank, *Reports of the Commission of Investigation into the Banking Sector in Ireland*, 2010, pp. 107-8; Occasional Papers 76| February 2011, The Economic Adjustment Programme for Ireland, European Commission.

⁽¹²⁾ Ibid., pp. 93-7, and Regling, K. and M. Watson, A preliminary report on the sources of Ireland's banking crisis, *Reports of the Commission of Investigation into the Banking Sector in Ireland*, 2010, p. 40, <http://www.bankinquiry.gov.ie/>.

⁽¹³⁾ See Breen, M., 'IMF surveillance of Ireland during the Celtic Tiger', *Irish Political Studies* 27 (3), 2012, pp. 431-9.

⁽¹⁴⁾ See IMF, 'Ireland: Financial System Stability Assessment Update', IMF Country Report No. 06/292, August 2006.

⁽¹⁵⁾ See OECD, Economic Survey for Ireland, Volume 2008/5, Paris, April 2008, p. 8.

sector debt on the public finances were not comprehensively analysed. But even the assessment of the fiscal situation did not prove fully adequate. While in 2002-03 the European Commission voiced concerns about the management of Ireland's public finances, assessments and recommendations became more lenient over the following years. Some commentators ascribe this to the fact that Ireland was running budget surpluses until 2007. ⁽¹⁶⁾ Even though some key vulnerabilities such as the pro-cyclical stance of fiscal policy and the strong dependence of tax revenues on the property market were clearly identified, the risk assessment appeared much too soft. This is exemplified in the European Commission assessment of the Irish stability programme of 2006: *"The risks to the budgetary projections in the programme appear broadly balanced. On the one hand, the macroeconomic situation, after a probably stronger than assumed starting position, could evolve less favourably than projected, and, associated with this, specific revenue sources, particularly those most closely linked to the housing market, could also be significantly weaker. On the other hand, other revenues taken together appear to have been projected cautiously, and in recent years expenditures have been contained within or close to planned levels....The overall conclusion is that the medium-term budgetary position is sound and, provided the fiscal stance in 2007 does not prove pro-cyclical, the budgetary strategy provides a good example of fiscal policies conducted in compliance with the Stability and Growth Pact."* ⁽¹⁷⁾

The effectiveness of fiscal surveillance had been compromised by asset bubbles which boosted budgetary revenues and provided a misleading picture of the soundness of the fiscal position prior to the crisis. When economic expansion is largely fuelled by asset bubbles and exuberant credit growth, fiscal revenues tend to be boosted by windfalls and the overall fiscal position becomes more vulnerable to cyclical downturns. Though understanding that the Irish housing boom was unsustainable, the European Commission, in line with the "Great Moderation" paradigm prevailing at that time, did not anticipate that the end of the housing boom could give rise to the dislocations that eventually emerged after 2007. With high cyclical revenues and potential output overestimated, estimates of the structural balance, an important tool to assess the underlying fiscal position, suggested an overoptimistic picture. As a result of the perceived fiscal soundness, successive Irish governments allowed excessive spending growth. With the onset of the crisis and the collapse of fiscal revenues, this entailed large budget deficits. ⁽¹⁸⁾ Even though international institutions and domestic sources voiced (limited) concerns, complacency prevented measures to assist effective crisis mitigation.

2.2. INITIAL RESPONSE BY THE IRISH AUTHORITIES AND EARLY ADJUSTMENT

The underlying vulnerabilities of the Irish economy, exacerbated by the collapse of global demand, were fully laid bare in autumn 2008. The Lehman debacle impaired interbank confidence and interbank lending, thus effectively derailing the funding model of the Irish banking sector. With hindsight, the Irish crisis was a matter of time, with and the negative spillovers from the global financial meltdown the catalyst that made the Irish banking system collapse like a house of cards. At the same time global demand declined. Ireland's main trading partners (the EA, the US and the UK) were going through a deep and sharp recession. Irish GDP declined by 9% in real terms and by 16.2% in nominal terms in 2008-10. The unemployment rate rose to 13.9% by end-2010, up from 4.7% at the end of 2007, with the construction sector accounting for half of the decline in total employment. Eventually, the combination of shrinking fiscal revenues and the large cost of the banking sector triggered a sovereign debt crisis.

⁽¹⁶⁾ See European Commission, Recommendation for a Council Opinion on the update of Ireland's Stability Programme, 2003-2005. For an assessment of country surveillance by different international financial institutions, see O'Leary, J., 'External surveillance of Irish fiscal policy during the boom', *Irish Economy Note*, No. 11, July 2010 and Eichengreen, B., 'The Irish crisis and the EU from a distance', Paper presented at the joint CBI-IMF-CEPR conference *Ireland – Lessons from Its Recovery from the Bank-Sovereign Loop*, Dublin Castle, 19 January 2015.

⁽¹⁷⁾ See European Commission, Economic assessment of the stability programme of Ireland (update of December 2006), Brussels 2007, pp. 5-6, http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/20_scps/2006-07/02_technical_assessment/2007-02-27_ie_ta_en.pdf

⁽¹⁸⁾ See European Commission, Report on public finances in the EMU 2014, *European Economy*, Vol. 9, 2014, p. 33.

In the initial phase of the crisis, the problems in the banking sector were largely misinterpreted as a liquidity and confidence issue, triggered by the global financial crisis. ⁽¹⁹⁾ Given that the economic downturn and financial turmoil made it difficult to distinguish effectively between illiquid and insolvent institutions, the Irish authorities initially issued a 'blanket' guarantee on banks' liabilities and provided a large amount of capital support. In practice in September 2008, the authorities issued a two-year guarantee on existing banks' liabilities (Credit Institutions Financial Support Scheme - CIFS) amounting to €375 billion (200% of GDP), in order to overcome banks' funding problems and address potential capital shortfalls. As a result, the solvency of the Irish sovereign and that of the banking system became directly intertwined. This eventually turned the banking crisis into a sovereign debt crisis. A further consequence of the guarantee was that the potential for any substantial burden sharing – by bailing in senior bondholders – was limited for its duration. ⁽²⁰⁾ With hindsight the bank guarantee appears too generous, and the fiscal impact could have probably been limited if banks had been subject to stricter requirements, as was the case in Sweden in 1991-92. ⁽²¹⁾ However, the Irish authorities were constrained by high uncertainty, the absence of any credible financial backstop mechanisms for the financial system ⁽²²⁾, and the potential for litigation from bondholders of domestic Irish banks. ⁽²³⁾ In December 2009, the Eligible Liabilities Guarantee Scheme (ELG) was introduced to facilitate debt securities issuance by credit institutions, and deposit taking with a maturity beyond September 2010. In addition, the CBI provided emergency liquidity assistance (ELA) to the banks that were left with only a limited amount of eligible collateral for repo transactions with the ECB. ⁽²⁴⁾

Uncertainty about the value of impaired assets and the high cost of banking sector support continued to undermine confidence in the Irish sovereign and Irish banks. Financial sector support also included an asset protection scheme and direct capital injections. In December 2009, the authorities established the National Asset Management Agency (NAMA), for the purchase, management and disposal of non-performing assets. ⁽²⁵⁾ However, the lengthy process that led to the eventual agreement on NAMA, and the initial uncertainty about the discount at which assets would be transferred to it, continued to erode investor confidence in banks' balance sheets. Eventually, haircuts proved to be much higher than the preliminary estimates. As of mid-January 2011, assets initially worth €71.3 billion had been transferred with an average discount of 58% on the nominal value. The 2010 Prudential Capital Assessment Review (PCAR) indicated additional capital needs for Irish banks ⁽²⁶⁾. However, these estimates became obsolete with the escalation of the banking crisis a few months later. Likewise, the results of the EU-wide stress tests published in July 2010 did not help clarify the situation of the Irish banking system, given that the main purpose of this exercise was to assess the resilience of the overall

⁽¹⁹⁾ See for example McGowan, M. A., 'Overcoming the banking crisis in Ireland', *Economics Department Working Paper No. 907*, OECD, November 2011, p. 6; Beck, T., 'Ireland's banking system – looking forward', in: G. Stull (ed.), *Future directions for the Irish economy, European Economy, Economic Papers*, No. 524, July 2014, p. 52.

⁽²⁰⁾ See Letter from the ECB President to Mr Matt Carthy, MEP, on several aspects of the Irish adjustment programme, http://www.ecb.europa.eu/pub/pdf/other/150218letter_carthy.en.pdf

⁽²¹⁾ For example, banks requesting support were obliged to give disclosure of all their financial positions and were dealt with in a way that minimised moral hazard, see Jonung, L., 'The Swedish model for resolving the banking crisis of 1991-93. Seven reasons why it was successful', *European Economy, Economic Papers*, No. 360, February 2009; Laeven, L. and F. Valencia, 'The use of blanket guarantees in banking crises', IMF Working Paper WP/08/250, IMF, Washington 2008.

⁽²²⁾ The EU governance tools allowing for the bail-in of (senior) creditors and set out in the Bank Recovery and Resolution Directive (BRRD) have been established only after the end of the Irish economic adjustment programme, see Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council.

⁽²³⁾ See Letter from the ECB President to Mr Matt Carthy, MEP, on several aspects of the Irish adjustment programme, http://www.ecb.europa.eu/pub/pdf/other/150218letter_carthy.en.pdf

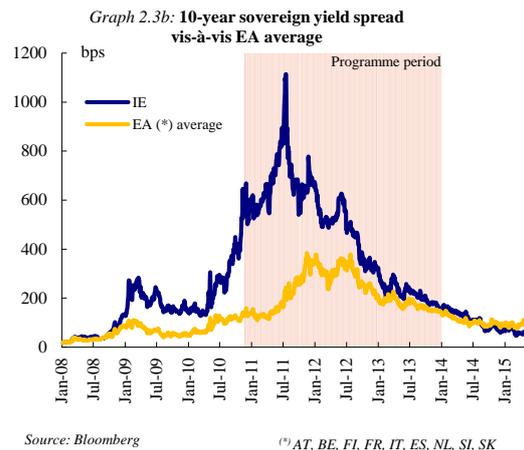
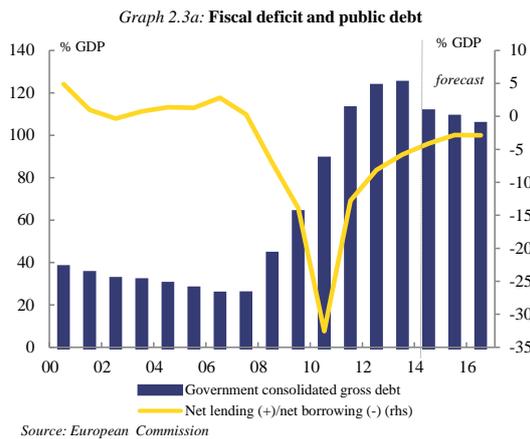
⁽²⁴⁾ Costs and risks related to the provision of ELA are borne by the national central bank. This implies that the Irish government is to ultimately bear the risk of potential losses from ELA as the owner of the central bank or as the issuer of a specifically provided state guarantee. This contingent exposure further exacerbated the dangerous nexus between banking risk and sovereign risk, see: <https://www.ecb.europa.eu/mopo/ela/html/index.en.html>.

⁽²⁵⁾ For further details on the set-up of NAMA, refer to section 5.

⁽²⁶⁾ See CBI, 'New levels of capital required for Irish banks', Press release of 30 March 2010, <http://www.centralbank.ie/press-area/press-releases%5CPages%5CFinancialRegulatorPublishesNewlevelsofCapitalRequiredforIrishBanks.aspx>

European banking sector. ⁽²⁷⁾ By the start of the programme, the government had injected €46 billion into five domestic financial institutions - of which €34.7 billion was into Anglo Irish Bank (Anglo)/Irish Nationwide Building Society (INBS) - partly through promissory notes (some €31 billion). ⁽²⁸⁾

The crisis also exposed substantial weaknesses in public finances, including a narrow tax base and strong reliance on cyclical tax revenue. The crisis revealed that cyclical revenues related to property transactions had been used to finance permanent increases in expenditure. Hence, when the property market crashed, fiscal revenues plunged. With public finances already under considerable strain, the necessary rescue of the banking sector marked the tipping point. The total cost of support measures in 2009-10 to the financial sector amounted to around one quarter GDP. The narrow general government deficit reached 11.1% of GDP in 2010, but the total fiscal deficit amounted to 32.5% including one-off rescue measures for the financial sector. General government gross public debt soared from 24% of GDP in 2007 to 87.4% by 2010 (see Graph 2.3a). In the third quarter of 2010, financial market concerns about the solvency of the Irish sovereign pushed spreads of Irish sovereign bonds vis-à-vis their German counterparts to unprecedented levels (see Graph 2.3b). This prompted the Irish authorities to publish estimates of the total costs of the support measures to the banking sector, with the aim to calming the markets.

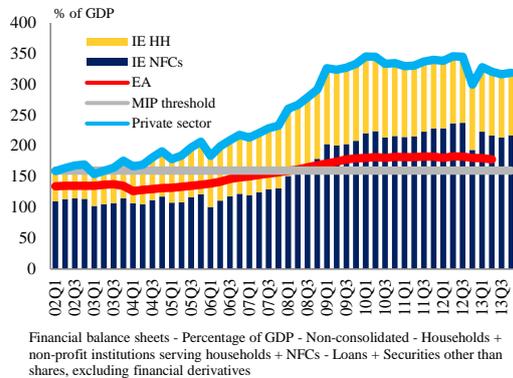


From mid-2008, five fiscal consolidation packages were implemented with a total net deficit-reducing impact of 9% of GDP in 2008-2010. Despite this substantial fiscal effort, the public finances worsened significantly. In 2008-09, the dramatic reduction in tax revenue was not matched by an equivalent adjustment of expenditure. Initially, public sector wages continued their upward trend in 2007 and 2008, before falling by 7% in 2009 and 6.2% in 2010. The Irish authorities committed to further savings from reductions in public sector employment and other administrative efficiencies. Nevertheless, a range of social benefits increased in real terms in 2009-10 because of the unanticipated fall in consumer prices. Cuts (and a reprioritisation) in capital expenditure were more frontloaded and incisive than cuts in current expenditure. The authorities outlined a four-year consolidation plan - the National Recovery Plan (NRP) for 2011-2014.

⁽²⁷⁾ The stress testing exercise – coordinated by the Committee of European Banking Supervisors (CEBS) – only covered Allied Irish Bank (AIB) and Bank of Ireland (BOI), which met the capital requirements and did not need additional capital beyond the amount set in March 2010 by the CBI and the Financial Regulator following completion of the PCAR.

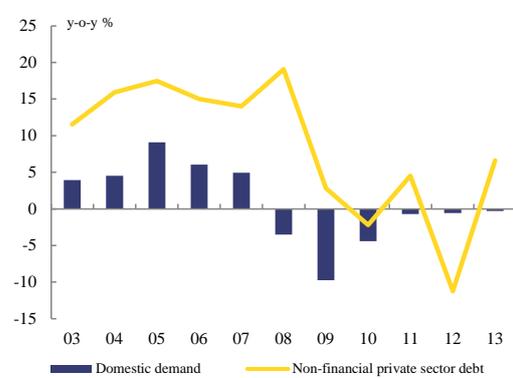
⁽²⁸⁾ Issued by the Irish government, promissory notes are IOUs (promises-to-pay) which qualified as core Tier 1 capital and hence tend to increase the Irish banks' regulatory capital adequacy ratio. Given that they constitute a government outlay in the year when they were issued, they immediately increase public debt.

Graph 2.4a: Private sector indebtedness



Sources: European Commission; Central Bank of Ireland

Graph 2.4b: Private sector deleveraging



Sources: European Commission; European Central Bank

The relatively high flexibility of the Irish economy paved the way for a rapid real adjustment. On the positive side, prices and wages reacted rapidly to the fall in demand; consumer prices declined by around 3.3% in 2009-10. This was mainly driven by a fall in the prices of goods, thus substantially reducing the pre-crisis inflation differential with other EA Member States. As noted above, cuts in public sector wages started in 2009. The current account deficit narrowed as a result of both the improvement in cost competitiveness and a contraction of domestic demand. The flipside of this necessary price adjustment was a real depreciation that increased the real debt burden, which tended to hamper the necessary deleveraging process (see Graph 2.4a and Graph 2.4b).

The early policy response to the banking crisis proved insufficient and liquidity support by the Eurosystem and the CBI reached its limits. In September 2010, the CIFS expired and a substantial amount of domestic banks' debt securities matured⁽²⁹⁾, while the outflow of non-resident deposits accelerated. The ensuing funding stress forced banks to draw on liquidity support from the Eurosystem. According to the CBI, Irish domestic banks received around €90 billion through collateralized monetary policy operations⁽³⁰⁾ at the peak in 2010. Moreover, the CBI provided ELA of about €50 billion to banks which were unable to pledge eligible collateral for standard monetary policy operations. By November 2010, Eurosystem support to Irish banks including ELA amounted to €140 billion, or around 85% of Irish GDP. In November 2010, then ECB President Trichet expressed concerns about the exposure of the Eurosystem to Irish financial institutions. He made clear that ECB authorization to provide additional ELA would be granted only after ensuring that this would not interfere with the objectives and tasks of the Eurosystem, or contravene the prohibition of monetary financing.⁽³¹⁾

The measures taken by the authorities prior to the request for financial assistance constrained the programme design. Between the onset of the crisis and the start of the EU/IMF financial adjustment programme the Irish authorities' attempts to address the problems of the financial sector reinforced the negative feedback loop between sovereign funding and bank funding stress. The blanket guarantees for bank creditors, the financial support already provided to the Irish banking system, and the creation of resolution vehicles such as NAMA presented the three institutions (European Commission, ECB, IMF) with a framework, where modifications appeared only possible at the margin. At the time of the programme request, the Irish sovereign had already assumed the bulk of the costs of rescuing the financial sector.

⁽²⁹⁾ After introduction of the CIFS guarantee (September 2008) and before the introduction of the ELG guarantee (December 2009), banks were raising wholesale funding mostly with maturities of up to the CIFS guarantee expiry date (September 2010). This led to a large amount of debt to be refinanced ("funding cliff") in October 2010.

⁽³⁰⁾ This included both the main refinancing operations and the longer-term refinancing operations (LTRO).

⁽³¹⁾ On 6 November 2014, the ECB published a letter written by former ECB president Jean-Claude Trichet on behalf of the Governing Council to the then Irish Finance minister Brian Lenihan in November 2010, <http://www.ecb.europa.eu/press/html/irish-letters.en.html>, see also Letter from the ECB President to Mr Matt Carthy, MEP, on several aspects of the Irish adjustment programme, http://www.ecb.europa.eu/pub/pdf/other/150218letter_carthy.en.pdf

3. OVERVIEW OF THE PROGRAMME

3.1. THE REQUEST FOR ASSISTANCE

On 21 November 2010, the Irish government requested financial assistance from the EU (through the EFSM), EU Member States (in the form of EFSF and bilateral loans) and the IMF. ⁽³²⁾ Irish sovereign bond spreads had surged to record highs and the public debt dynamics had made it impossible for Ireland to overcome the solvency crisis in its banking sector without external assistance. At the time of the request, the EFSM and the EFSF had recently been established, providing two mechanisms for delivering financial support to EA countries. The set-up of the EFSM and EFSF was such that any EA assistance programme was to be funded in conjunction with the IMF. ⁽³³⁾

The negotiations on an economic adjustment programme between the Irish authorities and the joint European Commission/ECB/IMF (the three institutions known colloquially as the Troika) mission team were concluded within a week of the programme request. However, discussions at official level between the Irish authorities and the three institutions had begun in the three months preceding the request to clarify the situation and explore possible responses to the crisis. A staff-level agreement on a policy package for the 2010-13 period was reached on 28 November 2010, when the Eurogroup and ECOFIN Ministers approved the adjustment programme and the financial package. ⁽³⁴⁾ On 7 December, the ECOFIN Council adopted the formal decision to grant financial assistance to Ireland ⁽³⁵⁾ and to recommend the extension of the deadline for bringing the fiscal deficit below 3% under the Excessive Deficit Procedure (EDP) by one year to 2015. ⁽³⁶⁾ The programme MoU was published on 8 December 2010, setting out policy reform requirements. The Dáil (the lower house of the Irish Parliament) approved the programme on 15 December. On 16 December, the IMF Board approved a loan arrangement on the basis of an Extended Fund Facility (EFF).

The immediate priority was to ensure enough funding was provided to break the financial-sovereign spiral of uncertainty, and to buy the Irish authorities enough time to institute the necessary reforms. The programme provided €7.5 billion in funding, to be disbursed in regular instalments, to add to the €17.5 billion of Irish reserves that would be drawn on over 2011-13, resulting in an overall package of €25 billion. At the time the programme was put together, there was much uncertainty about the magnitude of the needs of the financial sector and whether the Exchequer would be able to absorb these costs. The choice was made to have a substantial financial envelope to minimise the risk that it should prove insufficient and require a top-up or generate renewed uncertainty. Section 4 provides a detailed assessment of the financing envelope.

The key objective of the programme reforms was to restore financial market confidence in the Irish banking sector and sovereign and allow Ireland to make a sustained return to the markets. While the large envelope bought time, the reforms included in the programme aimed to ensure that the viability issues of the financial sector were addressed, that the costs of the banking support measures and continued budget deficits did not undermine the sustainability of public finances and that Ireland should emerge from the crisis able to grow strongly over the medium term. To achieve this, the programme contained i) a financial sector strategy comprising a fundamental downsizing and reorganisation of the

⁽³²⁾ Statement by the Eurogroup and ECOFIN Ministers, 21 November 2010, http://www.eurozone.europa.eu/media/368556/eg_and_ecofin_statement_ireland_21_nov_2010.pdf

⁽³³⁾ As set out in the EFSF framework agreement http://www.efsf.europa.eu/attachments/20111019_efsf_framework_agreement_en.pdf and EFSM regulation <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2010:118:0001:0004:EN:PDF>

⁽³⁴⁾ Statement by the Eurogroup and ECOFIN Ministers, 28 November 2010, http://www.eurozone.europa.eu/media/368582/statement_by_the_eurogroup_ecofin_28_nov.pdf

⁽³⁵⁾ Council Implementing Decision on granting Union financial assistance to Ireland, 7 December 2010, http://ec.europa.eu/economy_finance/articles/eu_economic_situation/pdf/2010-12-07-council_imp_decision_en.pdf

⁽³⁶⁾ Council Recommendation with a view to bringing to an end the situation of an excessive deficit in Ireland, 7 December 2010, <http://www.consilium.europa.eu/media/27796/st17210.en10recommendation%20ie.pdf>

banking sector, ii) a strategy to restore fiscal sustainability, and iii) a structural reform package to foster sustainable growth. These three strands can be thought of as addressing immediate, short and medium-term challenges and were intended to reinforce each other. The MoU included a timetable of policy reforms required for the disbursement of regular instalments of financial assistance.

The financial sector reforms aimed to draw a line under the immediate funding needs of the banking sector and to gradually introduce the changes necessary to return it to profitability. Hence drawing a line under the needs of the banking sector was seen as crucial in breaking the vicious financial-sovereign loop that had proven so damaging to the Irish economy. The Irish authorities' earlier attempts to address these issues acted as a constraint on what was possible under the programme. The financial sector was to be stabilised and recapitalised, following an in-depth assessment of its needs, with non-viable banks being resolved or merged. This would contain costs and was an absolute priority. Measures to clean up bank balance sheets and return the sector to a viable state, able to lend to the economy and underpin growth, were of equal, although not as immediate importance, to ensure that the sector could survive without needing to rely further on the state in future. Section 5 elaborates on financial sector reforms.

The fiscal reforms ultimately aimed at ensuring the sustainability of the Irish Exchequer. They sought to contain the continued increase in the public debt due to a large underlying general government deficit. In doing so, the consolidation effort under the programme continued on from the substantial efforts made over the previous years. The measures to be taken under the programme therefore appeared front-loaded which could have risked further depressing growth. However, the need to contain public debt was of primary interest in order to allow a sustainable return to the markets. In terms of setting up an appropriate budgetary policy for the future, the programme took its cue from the existing fiscal priorities of the Irish authorities and required the implementation of a strong agenda of measures to improve fiscal governance over the medium term. See section 6 for more details on the fiscal and fiscal governance reforms.

The Irish programme contained structural reforms which were aimed to support Ireland's return to strong and inclusive growth. Ireland went into the crisis as a flexible, dynamic, high income economy. These underlying strengths enabled significant progress in adjustment, effectively occurring before the programme had been put together. However, there was a lack of active labour market policies and the risk that high long-term unemployment could lead to hysteresis and permanent scarring of the productive ability of the economy. The need to rationalise costs in both the public and private sectors also brought other structural issues to the fore, as inefficiencies and inequities that could be accommodated in boom conditions became a much greater drag in times of crisis. Section 7 presents an overview of the structural reform policies.

The involvement of the Irish authorities in the preparation of the programme was substantive and aimed to ensure that Ireland retained the ownership of the programme requirements. A substantial part of the programme was based on preliminary work by the Irish authorities, which was influenced by consultations with the three institutions from mid-summer 2010. The Irish government published its National Recovery Plan (NRP) for 2011-2014 on 24 November 2010, three days after it requested financial assistance. ⁽³⁷⁾ This plan presented the government's roadmap to reduce the estimated underlying general government deficit to below 3% of GDP by 2014 and set out structural reforms to enhance competitiveness, growth and employment. ⁽³⁸⁾ The fiscal and structural reforms set out in the MoU were largely aligned with the NRP ⁽³⁹⁾. This choice was justified by a number of considerations. First, lengthy programme negotiations in the context of a rapidly worsening economic environment would have dealt a further blow to financial market confidence, both in Ireland and the EA as a whole. Second,

⁽³⁷⁾ National Recovery Plan 2011-2014, <http://www.budget.gov.ie/The%20National%20Recovery%20Plan%202011-2014.pdf>

⁽³⁸⁾ The deadline of 2014 corresponded to the one required by the existing Irish EDP. The MoU was based on the NRP measures reducing the deficit to below 3% of GDP by 2015, due to a more pessimistic macroeconomic scenario.

⁽³⁹⁾ See European Commission, 'The Economic Adjustment Programme for Ireland', *Occasional Papers*, No. 76, February 2011, pp. 59-78.

by increasing the Irish ownership of the programme, it was hoped that the public acceptance and delivery of the measures would be enhanced. Ireland's position was to only commit to adjustment measures that could be delivered, in order to enhance credibility.

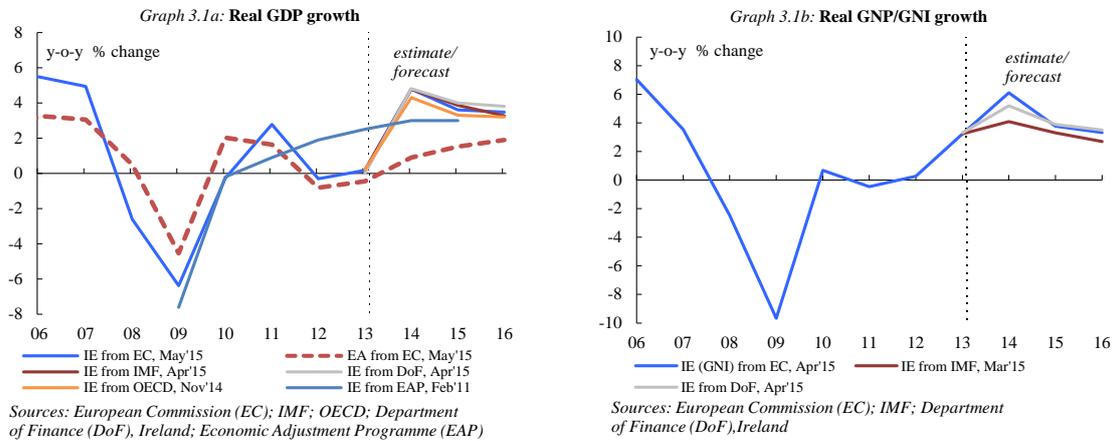
The programme design was premised on the Irish administration having both the capacity and the willingness to implement the programme. Effectively, interviewees stressed that the strong administrative capacity of Irish government was key to the decision to allow the programme to remain rather parsimonious and to steer clear of excessive micro-management. The Irish authorities created a special unit attached to the Treasury which was tasked with coordinating the reforms enacted under the programme and verifying the appropriateness of the measures taken. The unit acted as the contact point for the Troika, facilitating cooperation. When interviewed for this report, staff from both the Irish administration and the three institutions stressed that the pro-activeness of the Irish authorities in taking charge of the implementation was central to the strong delivery of the reforms in the programme.

3.2. THE OVERALL CONTEXT AND RESULTS OF THE PROGRAMME

The Irish programme was successful, with the Irish sovereign making a full and sustained return to financial markets before the end of the programme. With 18 months of strong programme implementations behind it, Ireland returned to the bond markets in July 2012 and gradually built up its market presence. As Irish spreads continued to fall, Ireland was able to access longer term and cheaper debt instruments than the programme had forecast would be possible. The savings this generated came on top of the lower than expected cost of the banking sector recapitalisations and better than forecast fiscal outcomes. All this allowed Ireland to build up a sizeable cash buffer by the end of the programme. As a result, a virtuous circle of credibility led to Ireland leaving the programme able to borrow at a rate of 3.4% for a 10 year bond. Yields continued to fall, reaching a level below 2% by the end of 2014.

Economic outcomes had improved substantially by the end of the programme. Ireland unevenly recovered from the deep slump it was in in 2010. It is worth noting that credit-fuelled booms often lead to deeper recessions and slower recoveries, as high deleveraging needs in the private and public sector shackle economic activity. ⁽⁴⁰⁾ As Graph 3.1a shows, compared with projections made at the start of the programme, the economy stabilised and rebounded more strongly than expected in 2011. Although GDP growth was significantly weaker than forecast in both 2012 and 2013, Ireland still fared better than many other EA countries. The Irish economy returned to strong expansion in 2014, growing at 4.8%. Overall, Irish growth over the programme period outpaced both the EA average and other programme countries. Section 8 provides more details.

⁽⁴⁰⁾ Jordà, O. et al., 'When credit bites back', *Journal of Money, Credit and Banking*, Supplement to Vol. 45, No. 2, December 2013, pp. 3-28.



In looking at the economic situation in Ireland, it is important to consider the impact of foreign-owned companies and the composition of Irish exports. Due to the large stock of FDI, GDP dynamics are partly determined by the development of net factor incomes. Gross National Income (GNI) strips out the impact of income repatriated to non-residents from the large foreign-owned multi-national companies (MNCs). GNI figures, which suggest a smoother and more gradual recovery, appears the more appropriate metric for assessing the state of the economy. The more robust performance of GNI better reflects the relative health of the domestic economy. Starting from 2011, when it declined by 0.5%, Irish GNI increased without interruption in the period 2012-14 and is estimated to expand closely in line with GDP in 2015-16 (see Graph 3.1b). Unemployment rose more than expected to a peak of 15.1% in late 2011, since when it has fallen steadily. Ireland's trade structure proved beneficial due to its high exposure to not just the EA, but also to the UK and US markets. The Irish economy was thus relatively well positioned to profit from the global recovery while EA growth remained weak.

The flexibility of the Irish economy meant that economic adjustment was well under way before the programme started. In order to gain competitiveness, as a member of a currency union Ireland had to adjust by means of internal devaluation. This means decreasing prices and wages relative to its peers. It also entails a shift in relative prices in tradable versus non-tradable goods, to induce a reallocation of resources to the more productive tradable sector. In Ireland, there was an abrupt fall in real unit labour costs, particularly in 2010, inflation plummeted between 2009 and 2010, the Real Effective Exchange Rate and the current account balance started improving already in 2009 (see section 8). The resumption of Irish economic growth was therefore rooted in adjustment before the programme. That said, the challenges generated by a major shock such as the financial crisis can still have a permanent impact on the economy. For example, the emphasis on active labour market policies was important for combatting long-term unemployment and supporting a sustainable and broad recovery.

Policy decisions before and during the programme helped Ireland regain credibility. The fiscal consolidation measures taken before the programme were as substantial as those taken during the programme. This set the scene for the budgetary response of the Irish authorities to be seen as credible by the markets. The results of the 2011 PCAR exercise, which estimated the capital needs of the banking sector to be well within the envelope of the programme, and below the amount assumed even without the contingency reserve, served to draw a line under the possible direct impact of the banking sector on the Exchequer. The solution to the uncertainty surrounding the status and impact of the promissory notes also served to reduce uncertainty. Once the immediate threats to solvency and sustainability were past, and the magnitude of the banking support measures were known, the commitment shown by the Irish authorities in tackling their fiscal problem stood Ireland in good stead on the financial markets. Ireland made what proved to be a strong and sustained return to the markets in 2012, despite a debt that had increased by nearly 100% of GDP over 5 years and a general government deficit still standing at 8% of GDP.

Box 3.1: The particular context of the euro area

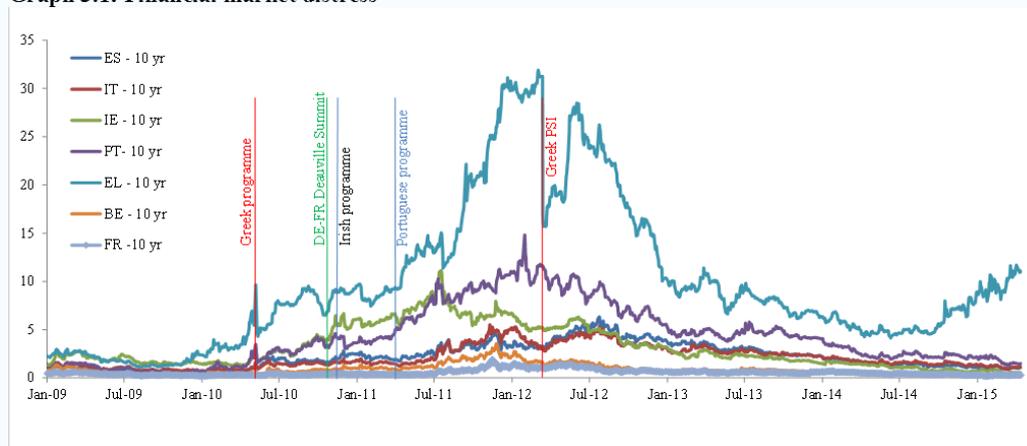
Facing the crisis with an incomplete architecture

The Irish adjustment programme needs to be seen in the broader EA economic and political context at the end of 2010.

The economic and financial crisis erupted in 2007 with the sharp correction of the US real estate sector. Non-performing subprime mortgages caused severe stress for financial institutions, culminating in the collapse of Lehman Brothers in September 2008. The EU and EA were not immune to problems in the US economy. But many European economists and policy makers were convinced that the economic impact on the EU would be limited. For example, the European Commission's 2007 Autumn Forecast still projected robust EA growth of over 2% for each of the years 2007, 2008 and 2009. However, the EA outlook then deteriorated rapidly. The situation deteriorated further with the Spring 2009 forecast projecting a recession for both 2009 and 2010 (real annual GDP growth of -4% and -0.1%, respectively). In reality, the EA economy shrank by 4.5% in 2009, before expanding by 2% in 2010 in real terms.

The rapidly deteriorating economic outlook was also reflected in sharply rising sovereign borrowing costs for many EA Member States. Spreads compared to the German 10-year Bund widened and reached unprecedented levels for some countries by mid-2010. First, this triggered a crisis in Greece where on top of the weakness of the economy serious concerns emerged regarding the reliability of Greek fiscal data. Financial market stress spread to Ireland and Portugal shortly afterwards. Other countries including Italy, Spain, Belgium or France were also affected to a lesser extent.

Graph 3.1: Financial market distress



Source: European Commission, Bloomberg

In the face of this rapidly deteriorating economic and financial environment, it became obvious that the EA lacked adequate means to deal with a crisis in one Member State which had the potential to rapidly turn into a systemic one. EU-level firewalls to prevent spill-overs and protect individual Member States from economic meltdown, default and potentially EA exit did not exist. Initially, financial assistance to Greece had to be granted via bilateral loans from EA Member States, which were pooled by the European Commission in the Greek Loan Facility (GLF). Against this background, EA Member States and EU Institutions took a series of decisive steps to rapidly create a framework that would enable the EA to deal with this and potential future crises.

(Continued on the next page)

Box (continued)

- In May 2010 the EFSF was created on a temporary basis to provide financial assistance to EA Member States in difficulties conditional on appropriate policy reform. The EFSF was set up with a lending capacity of EUR 440bn, guaranteed by EA Member States. Initially, EFSF funds were only available in the form of loans to finance macro-economic adjustment programmes incorporating far-reaching policy conditionality. However, by July 2011 EA Member States realised that the scope of potential EFSF activity needed to be broadened ⁽¹⁾ to also offer i) precautionary programmes, i.e. credit lines, ii) finance the recapitalisation of financial institutions through loans to governments, including in non-programme countries, and to iii) intervene in the secondary bond markets. These new features became operational by mid-October 2011. ⁽²⁾
- In parallel, the EFSM was set up to provide financial assistance to all EU Member States in financial difficulties, thus going beyond the EA. Under the EFSM, the European Commission is allowed to borrow up to a total of EUR 60bn in financial markets backed, by the EU budget. The European Commission then can lend this money on to the beneficiary Member State in the context of a macroeconomic adjustment programme based on strict conditionality agreed with the European Commission, in liaison with the ECB.
- As early as December 2010, EA Member States envisaged the creation of a permanent crisis resolution mechanism, the European Stability Mechanism (ESM), based on paid-in capital and with a maximum lending capacity of EUR 500bn. The intergovernmental Treaty establishing the ESM was signed in February 2012 and the ESM was officially inaugurated on 8 October 2012. ⁽³⁾
- Work on a Banking Union started in 2012. At the same time EA Member States shifted away from the principle of bailing-out all investors. Under rising public pressure, "bail-in" to recapitalise financial institutions were no longer considered taboo, and the fear of EA wide contagion had receded markedly. The Bank Recovery and Resolution Directive (BRRD) was adopted in April 2014. The BRRD mandated the bail-in of those liabilities not backed by assets or collateral before an institution can be recapitalised with public funds (national or European). The simultaneous adoption of the Single Resolution Mechanism (SRM), the strengthening Deposit Guarantee Schemes (DGS), and the prior creation of the Single Supervisory Mechanism (SSM) provided the legal basis for making the European Banking Union operational.
- The ECB also took decisive measures. In May 2010, it announced the Securities Markets Programme (SMP). Under the SMP, the ECB could buy securities that were normally accepted as collateral in its refinancing operations, with the aim of ensuring depth and liquidity in the markets. Further additional non-standard measures were subsequently taken, such as increasing the maturity of the long-term refinancing operations (LTROs) up to 36 months. The ECB also increased the scope of assets eligible for collateral under its refinancing operations, and suspended the application of the minimum credit rating threshold for sovereign bonds of countries under an adjustment programme. These measures became applicable for Ireland in March 2011. Finally, during a speech in London on 26 July 2012, President Draghi assured markets that, within its mandate, the ECB was "ready to do whatever it takes to preserve the euro" he followed-up on this statement by replacing the SMP with the "Outright Monetary Transaction" programme (OMT) in September 2012. The mere announcement of possible, unlimited *pari passu* central bank intervention helped calm down financial markets. Yields on peripheral Member States' sovereign bonds gradually returned to more normal levels.

⁽¹⁾ http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/123978.pdf

⁽²⁾ The EFSF did not provide instruments to recapitalise financial institutions directly ("direct bank-recap"). Direct bank-recaps were added to the ESM's range of financial assistance instruments on 8 December 2014. Retroactive application of direct bank recaps is possible in principle but depends on a case-by-case assessment and the mutual agreement of ESM Members.

⁽³⁾ The ESM has effectively replaced the EFSF. Since 1 July 2013, the EFSF is no longer engaged in new financing programmes but continue to finance programmes that started before the ESM Treaty was signed. The EFSF will be dissolved and liquidated when all financial assistance provided to EA Member States and all funding instruments issued by the EFSF have been repaid in full.

(Continued on the next page)

Box (continued)

- Economic governance and budgetary surveillance have been strengthened significantly. In September 2011, the "six-pack", a legislative package of five Regulations and one Directive, was adopted, entering into force in December 2011. In addition to strengthening fiscal surveillance, the "six-pack" introduced the concept of macroeconomic surveillance with the creation of a new Macroeconomic Imbalance Procedure (MIP).
- In January 2013, the Treaty on Stability, Coordination and Governance entered into force. This intergovernmental treaty, which is binding for EA countries, required among other things the introduction of "balanced-budget rules" in national legislation, preferably at a constitutional level. This specific provision has become better known as the "fiscal compact".
- Finally, in May 2013, the "two pack", a legislative package of two Regulations applicable to EA Member States, entered into force. This introduced a further strengthening and better coordination of the surveillance mechanisms in the EA (e.g. submission and approval of draft budgetary plans, enhanced surveillance in case of non-compliance with the MIP and the preventive arm of the SGP).

External factors were also important in supporting a recovery which, although weaker than originally forecast, was substantially stronger than in peer countries. The sustainability of the Irish public finances also received a boost from the reduction on the margins payable on the EFSF and EFSM loans and the extensions of maturities. Crucially, global market financing conditions became more benign. Ireland was able to capitalise on its renewed credibility at a time of shrinking spreads. After Ireland returned to the market in the second half of its programme it benefitted from consistently falling yields. Policy action by the ECB, including the commitment to "do whatever it takes" and the launch of the 'Outright Monetary Transaction' programme (OMT), were central to the improvement in the external market environment. Box 3.1 provides more details.

4. SIZE AND TERMS OF THE EFSM/EFSF FINANCIAL ASSISTANCE

The funding envelope of €85 billion agreed in December 2010 was aimed at providing sufficient financing for Ireland over the 3 year programme period to ensure a smooth return to full market funding. The financial envelope needed to cover the government cash deficit, the redemption of maturing short-term, medium- and long-term public debt, and a sufficient recapitalisation of the banking sector. While the first two elements could be forecast or projected – at least within certain reasonable bounds – the magnitude of the funds required to recapitalise the banking sector was subject to high uncertainty prior to bank balance sheet assessments and an asset quality review. This is also highlighted by the capital injections in the banks by the Irish authorities prior to the programme, which proved ineffective in restoring confidence in the banking sector. The task was complicated by high volatility in EA financial markets. Finally, the size of the funding envelope was also influenced by the policy decisions that had been taken by the Irish authorities prior to the request for external financial assistance.

4.1. THE FINANCING ENVELOPE

The Irish adjustment programme was underpinned by a financial envelope of €85 billion, corresponding to approximately 50% of Irish GDP. This envelope consisted of €17.7 billion from the EFSF⁽⁴¹⁾, €2.5 billion from the EFSM⁽⁴²⁾, €2.5 billion from the IMF via an EFF, bilateral funding of €3.8 billion from the UK, €0.6 billion from Sweden, €0.4 billion from Denmark and €17.5 billion from Irish national funds.

Estimates of gross financing needs, and a gradual resumption of market access, indicated a substantial funding gap. At the start of the programme, the total financing needs of the Irish sovereign, including up to €35 billion for potential banking recapitalisations, were projected at €134 billion until December 2013. The largest component was the broad cash public deficit which included a promissory note component and the narrow exchequer deficit (central fund deficit). It was forecast to amount to €9.4 billion over the programme period. This aggregate figure was based on projected general government deficits of 32.0% of GDP in 2010⁽⁴³⁾, 10.6% in 2011, 8.6% in 2012 and 7.5% in 2013. The roll-over needs of maturing sovereign debt were projected at €9.6 billion, while €35 billion were budgeted for bank recapitalisations. The redemption of medium and long-term sovereign debt amounted to €16 billion. The short-term debt falling due in the programme period was projected at €16.7 billion (€10 billion of treasury bills and €6.7 billion of commercial paper) and €6.9 billion of retail debt.⁽⁴⁴⁾ Based on the assumption that Ireland would regain market access over the programme horizon, the net financing needs of the public sector were estimated at €50 billion. In addition, the projected capital needs of the banking sector had to be funded. This implied a funding gap of €85 billion to be covered by external assistance and internal funding (see Table 4.1).

This financial package was calculated to ensure that Ireland would be able to meet its fiscal targets, roll-over its maturing medium- and long-term debt and provide sufficient funds to recapitalise its banking sector, even under adverse circumstances. Ireland was expected to keep rolling over its existing debt and to raise €1.1 billion of additional longer-term debt by 2012 and €4.8 billion in 2013. Ireland was the first country to take out loans from both the EFSF and the EFSM, in combination with IMF lending.⁽⁴⁵⁾ Two thirds of the loans were provided by EU Member States and one third came from

⁽⁴¹⁾ The EFSF, a private company incorporated in Luxembourg, was created by EA Member States in June 2010.

⁽⁴²⁾ The EFSM is a Union instrument based on Article 122 of the Treaty for the Functioning of EU, established in May 2010. Previously, financial assistance had only been available under Article 143 to finance Balance of Payments (BoP) programmes in non-EA Member States.

⁽⁴³⁾ The government deficit of 2010 includes bank rescue costs.

⁽⁴⁴⁾ This includes prize bonds, savings bonds and certificates and Post Office deposits.

⁽⁴⁵⁾ The EFSF was set up shortly after the financial assistance programme for Greece was agreed in May 2010. The first Greek programme was the first occasion that financial assistance had been provided to an EA Member State. Since no mechanism or facility existed to manage lending and borrowing operations, the Greek Loan Facility was constructed by pooling bilateral loans

the IMF. Although the funding sources were distinct, Ireland's compliance with conditionality linked to all the loans was assessed by the three institutions on behalf of all creditors. The bilateral loans from the UK, Sweden and Denmark were not linked to any specific conditionality or collateral requirements. ⁽⁴⁶⁾

Table 4.1:
Estimated financing needs and sources at programme outset, EUR bn

	Dec-2010 2011-Q1	2011 Q2	2011 Q3	2011 Q4	2010/11 Year	2012 Year	2013 Year	2010-2013 Total
A. Gross financing needs public sector	16.1	10.3	4.9	8.9	40.2	29.5	29.2	98.9
Exchequer cash deficit, incl. promissory notes 1/	7.0	8.6	4.5	3.1	23.2	18.7	17.4	59.4
Long-term debt securities, maturing	0.0	0.0	0.0	4.4	4.4	5.6	6.0	16.0
Short-term debt, maturing	7.0	1.4	0.1	1.2	9.6	3.4	3.7	16.7
Treasury Bill	4.7	1.2	0.0	0.1	6.0	2.0	2.0	10.0
Commercial paper	2.3	0.1	0.1	1.1	3.6	1.4	1.7	6.7
Retail debt	2.1	0.3	0.3	0.3	3.0	1.8	2.1	6.9
B. Debt issuance/ Roll-over	5.4	1.5	1.0	2.0	9.8	12.3	26.8	48.9
Exchequer cash deficit, financing	0.0	0.0	0.0	0.0	0.0	3.7	14.0	17.7
Long-term debt securities, issuance	0.0	0.0	0.0	0.0	0.0	1.1	4.8	5.9
Short-term debt, issuance	2.7	0.5	0.1	1.1	4.5	3.7	3.8	12.0
Treasury Bill	1.6	0.4	0.0	0.0	2.0	2.0	2.0	6.0
Commercial paper	1.2	0.1	0.1	1.1	2.5	1.7	1.8	6.1
Retail debt	2.7	0.9	0.9	0.9	5.4	3.8	4.2	13.3
C. Net financing needs public sector (A-B)	10.7	8.8	3.9	7.0	30.4	17.2	2.5	50.0
Budget deficit and promissory notes	7.0	8.6	4.5	3.1	23.2	15.0	3.5	41.7
Long-term debt	0.0	0.0	0.0	4.4	4.4	4.5	1.2	10.0
Short-term debt	4.3	0.8	0.0	0.1	5.1	-0.3	-0.2	4.6
Treasury Bill	3.2	0.8	0.0	0.1	4.0	0.0	0.0	4.0
Commercial paper	1.1	0.0	0.0	0.0	1.1	-0.3	-0.2	0.6
Retail debt	-0.6	-0.6	-0.6	-0.6	-2.4	-2.0	-2.1	-6.4
D. Bank recapitalization	13.8	7.5	3.7	0.0	25.0	5.0	5.0	35.0
Direct capital injection 2/	7.0	0.0	0.0	0.0	7.0	0.0	0.0	7.0
Further capital provisions	6.8	7.5	3.7	0.0	18.0	5.0	5.0	28.0
TOTAL - FINANCING NEEDS (C+D)	24.5	16.3	7.6	7	55.4	22.2	7.5	85
Use of Ireland's financial buffers 3/	6.9	3.8	1.9	0	12.5	2.5	2.5	17.5
EU-IMF loan disbursement	17.6	12.6	5.8	7	42.9	19.7	5	67.5
EU (incl. MS bilateral loans)	11.7	8.4	3.9	4.6	28.6	13.1	3.3	45
IMF	5.9	4.2	1.9	2.3	14.3	6.6	1.6	22.5
TOTAL - FINANCING	24.5	16.3	7.6	7	55.4	22.2	7.5	85

Notes:

1/ Includes interest payments.

2/ Capital injections to domestic banks to meet higher Core Tier 1 ratios.

3/ Includes Treasury cash buffer and investments by the National Pension Reserve Fund.

Source: European Commission.

from EA countries. Alongside the first Greek programme, the EFSF and EFSM were set up to provide a mechanism should other EA Member States request financial assistance. Ireland was the first country to require external financing after Greece. ⁽⁴⁶⁾ According to the Irish authorities (Department of Finance), none of the countries providing bilateral loans to Ireland as part of its bail-out have sought loan guarantees.

The gross financing needs included €35 billion for bank recapitalisation but this amount was not ring-fenced in the financial envelope. This relatively large volume reflected the need to have a contingency buffer of €10 billion given the inherent uncertainty in forecasting the needs of the banking sector. The prospective funding requirements of the banking sector were the most uncertain part of the estimates of financing needs; the provisions made for this purposes in the financing estimates were set in a way as to provide a credible buffer that would be sufficient under adverse scenarios.

The financial envelope was based on the assumption that Ireland would have sufficient market access to cover a significant part of its financing needs. From the beginning of the programme, Ireland was expected to maintain access to short-term market funding, and return to medium and long-term market funding from 2012 onwards. As a consequence, the estimated financing needs were premised on Ireland being able to raise some €48.9 billion in the markets over the programme period.

The size of the envelope was also determined by political considerations in creditor countries. Interviews with the Irish authorities, staff from the three institutions and the EFSF/ESM suggested that the figure of €85 billion was to some extent the result of "reverse-engineering". This implies that the total financing envelope was not solely derived from estimates of Ireland's financing needs, but was also influenced by the total amount creditor countries were willing to lend to Ireland.

A special feature of the Irish programme is the Irish contribution of €17.5 billion from accumulated reserves in the Treasury cash buffer and NPRF. ⁽⁴⁷⁾ The decision of the Irish government to explicitly contribute €17.5 billion of national funds to the programme was motivated by three factors. Firstly, there was the need to impress the markets with a sizeable financial package. Secondly, the Irish authorities were anxious to show other creditors that Ireland was making a contribution. Finally, the yields on these funds were lower than the cost of external financing under the programme. In addition, the need for Ireland to retain large cash buffers was reduced once the programme started because it guaranteed (subject to adherence to conditionality) external funding. It was nevertheless agreed that the cash reserves of the Treasury and the discretionary portfolio of the NPRF should not fall below €5 billion, to ensure a sufficiently large cushion for any extra financing needs. Net of the Irish contribution, the funding gap to be covered by official lenders amounted to €67.5 billion. ⁽⁴⁸⁾

4.2. THE ADEQUACY OF PROGRAMME FINANCING

Over the programme, Ireland's total gross financing needs proved much smaller than originally projected. The total cash deficit was €7.7 billion lower than estimated ⁽⁴⁹⁾, while debt redemptions absorbed €2 billion less than expected. Moreover, following the 2011 PCAR, the banks' capital needs were set at €24 billion. This implied that the Irish State had to provide €16.6 billion. ⁽⁵⁰⁾ After adding €1.6 billion, disbursed in 2012 to cover further financial sector needs, ⁽⁵¹⁾ the gross public cost of banks' rescue amounted to slightly over €18.1 billion. This is €16.9 billion lower than initially allocated in the programme envelope. ⁽⁵²⁾ On the other hand, larger than expected outlays for small and medium-sized

⁽⁴⁷⁾ These funds provided half of the contributions to banks' capital needs.

⁽⁴⁸⁾ For comparison, the financing package for Cyprus amounted to €10 billion. Under the first programme, Greece was granted €10 billion (followed by a much expanded second programme) and Portuguese programme consisted of €78 billion. The Spanish financial sector programme had an envelope of €100 billion.

⁽⁴⁹⁾ The lower-than-projected cash deficit over the programme horizon mainly results from one-off developments and financial sector transactions in 2013, including the sale of Irish Life and Bank of Ireland (BoI) contingent capital instruments amounting to receipts of around €2.5 billion, see Department of Finance, *Budget 2014. Economic and Fiscal Outlook*, 2013, p. C12. <http://budget.gov.ie/Budgets/2013/Documents/Budget%202013%20-%20Economic%20and%20Fiscal%20Outlook.pdf>.

⁽⁵⁰⁾ For a detailed overview of the recapitalisation of the Irish banking sector, see section 5.2.1 and especially table 5.2.

⁽⁵¹⁾ Out of that, €1.3 billion were injected by the State to temporarily cover the sale of Irish Life, which was finalized in 2013.

⁽⁵²⁾ The total gross costs of banking sector repair amounted to €64.1 billion (or 41% of 2011 GDP) with the bulk of it having been incurred prior to the programme. For more details see the National Treasury Management Agency (NTMA) Presentation for Institutional Investors, 'Ireland: Programme exit achieved', *NTMA*, January 2014, p. 69, http://www.ntma.ie/download/investor_presentation/January%20Presentation.pdf.

enterprises (SME) and the health care sector required an additional €1.5 billion. As a result, Ireland's gross funding needs were €25.3 billion lower than anticipated at programme inception.

Even though the financial envelope turned out to be larger than the actual financing needs, its size appears justified. The financing package for Ireland was intended to be a credible solution that would be sufficient even under adverse scenarios. The fact that sovereign bond spreads kept rising in late 2010 and early 2011 has been frequently attributed to external factors, most notably the informal Deauville accord between German Chancellor Merkel and French President Sarkozy. ⁽⁵³⁾

The inclusion of a buffer of €10 billion for bank recapitalisation needs was warranted by high volatility in financial markets and uncertainties about the capital needs of Irish banks. ⁽⁵⁴⁾ By definition, a buffer primarily exists to deal with contingencies. It is only expected to be used in cases of deviations from the central scenario. Given the initial uncertainty about asset quality the provision of sufficiently large contingency reserves was essential to restore confidence. At the beginning of 2013, the pillar banks had regained access to debt markets and the resolution of non-viable banks had been completed. Only then was it legitimate to conclude that downside risks related to the financial sector were unlikely to materialize, and that contingency reserves would not need to be used.

The adequacy of the financial envelope was also linked to a smooth and realistic consolidation path for the fiscal deficit. Nominal deficit targets were set to decrease from 10.6% in 2011 to 7.5% in 2013. The fiscal deficit targets used as a basis for the calculations of the financing envelope were based on a macroeconomic scenario that proved to be realistic. ⁽⁵⁵⁾

Despite the lower-than-forecast financing needs, Ireland received the full programme funding, enabling it to borrow less on the market than initially projected and to increase its cash buffer over the programme period. Overall, Ireland borrowed €32.3 billion from the markets rather than the projected €48.9 billion. The Treasury was also able to shift the composition of new issuances towards medium and long-term debt instruments, taking advantage of low global yields and the rising risk appetite of international investors (see Graph 4.2b). Over the programme, Ireland issued long-term bonds worth €16.0 billion, exceeding initial expectations by more than €10 billion. By contrast, the Treasury only issued €16.3 billion of short-term and retail debt, some €5.3 billion less than forecast. With new borrowing requirements €16.6 billion lower and financing needs reduced by €25.3 billion, Ireland was able to reduce its own contribution and replenish the Treasury cash buffer over the programme period (see Graphs 4.1a and 4.1b). ⁽⁵⁶⁾⁽⁵⁷⁾

⁽⁵³⁾ On 19 October 2010, Angela Merkel and Nicolas Sarkozy agreed that in the future, sovereign bailouts from the European Stability Mechanism would require that losses be imposed on private creditors.

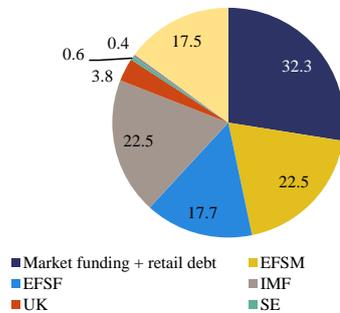
⁽⁵⁴⁾ NTMA returned to the markets with a 5-year benchmark bond by way of a syndicated tap in January 2013, and a new 10-year benchmark bond in mid-March 2013.

⁽⁵⁵⁾ See González Cabanillas, L. and Terzi, A., 'The accuracy of the European Commission's forecasts re-examined', *European Economy*, Economic Papers, No. 476, December 2012.

⁽⁵⁶⁾ See European Commission, 'Economic adjustment programme for Ireland – Autumn 2013 review', *European Economy, Occasional papers*, No. 167, December 2013, p. 39, <http://budget.gov.ie/Budgets/2013/Documents/Budget%202013%20-%20Economic%20and%20Fiscal%20Outlook.pdf>.

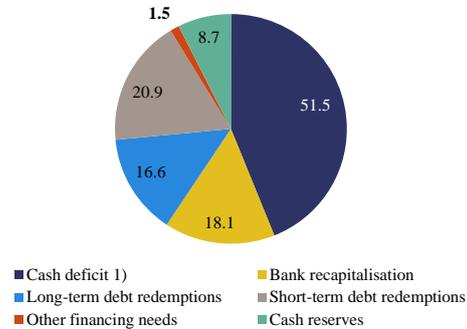
⁽⁵⁷⁾ At programme exit the cash buffer was therefore quite robust and could cover all sovereign financing needs for more than 12 months ahead.

Graph 4.1a: Source of funding over the programme period, Dec. 2010-13, EUR bn



Source: European Commission, CSO.

Graph 4.1b: Use of funds, Dec. 2010-13, EUR bn

Source: European Commission, CSO.
1) Includes promissory notes payments.

4.3. THE RATIONALE OF CONTINUED DISBURSEMENTS AND CHANGES IN LENDING TERMS

In principle, the disbursement of the official financing package could have been reduced or even stopped towards the end of the programme. This issue was discussed with programme participants in the context of the evaluation. As a principle, programme disbursements should match financing needs, including the build-up of an adequate Treasury cash buffer. In the Irish programme, the increase in cash reserves was substantial and allowed Ireland to exit the programme with a sizeable cash buffer (about €20 billion at the final programme review). This was an important factor in Ireland's decision not to request a follow up precautionary programme. The Irish authorities and market participants voiced concerns that reducing or stopping the disbursement of financial assistance, and thus effectively impeding the build-up of a considerable cash buffer, might have driven up sovereign funding costs given the implied higher risk. Moreover, the issue of not disbursing the last tranches of the programme envelope was never formally discussed. This is also confirmed by the replies from Eurogroup Working Group (EWG) members. The EFSF/EFSM also stressed that, though a disbursement decision is at the discretion of the EFSF's Board of Directors, the political aspects of a potential stop to disbursements are anything but clear cut. Even though interviewees pointed to different degrees of discretion in assessing the decision to disburse, a consensus existed among interlocutors that a formal decision by the EWG/EFSF Board of Directors or the Council following the completion of a review would have been necessary to stop disbursements. This might eventually have entailed adding a provision to the MoU and seeking a corresponding Council Implementing Decision (CID). In order to prevent such a scenario in the future, respondents suggested that disbursements could be directly linked to both policy conditionality and financing needs. ⁽⁵⁸⁾

Another way to avoid/limit the disbursement of the full financial envelope would have been to ring-fence the bank recapitalisation envelope at the outset of the programme. Since the funds that needed to be injected into the banking sector were ultimately limited to €8.1 billion rather than €35 billion, such an earmarking – a feature of some other programmes – would have required a specific request by the recipient Member State and an explicit decision by creditors. This would have somewhat reduced the flexibility of the programme to respond to negative events. It is an open question if the cash buffer, which is likely to have facilitated market access already during the programme, could have been built up at a later stage after the programme. However, the cash buffer was an important element in the successful exit from the programme.

⁽⁵⁸⁾ This proposal is in line with common IMF policy which allows for the transformation of any disbursement into a precautionary programme, once a funding gap has ceased to exist.

The diverging lending terms of EFSF/EFSM and IMF loans raise questions for the future. Initially, the lending terms for the EFSF/EFSM loans included interest rate margins, which were tailored to match the level of interest rates of IMF loans, taking into consideration that EFSF/EFSM lending was based on back to back lending with fixed rates, while rates for IMF loans were flexible. ⁽⁵⁹⁾ Again copying IMF lending policy, the EFSF/EFSM financial assistance framework agreement also included a proportionate early repayment clause that required the Irish borrower to reimburse all creditors proportionally in case of an early repayment. The initial inclusion of EFSF/EFSM margins responded to the request of some creditors, who sought to avoid moral hazard and see the beneficiary Member State return to market funding as soon as possible. However, these margins made it more difficult for recipients to achieve debt sustainability and made potential market investors wary about market access. Hence, as was done previously for the Greek Loan Facility, the Council decided on 11 October 2011 to cancel the EFSF/EFSM margins. In addition, Ireland benefited twice from substantial extensions of maturity of EFSM/EFSF loans. ⁽⁶⁰⁾ The easing of EFSF/ESM lending terms lightened the debt burden and contributed to a faster market access. Hence, they also reduced the need for official assistance. However, EFSF/EFSM lending also became substantially more attractive than IMF loans, which include interest rate margins for both exceptional access and loans outstanding for more than 3 years. With declining yields, IMF margins also made IMF loans increasingly more expensive than market financing. As a result, Ireland requested the proportionate early repayment clause be waived, to enable an early repayment of IMF loans in October 2014. ⁽⁶¹⁾ The original alignment of IMF and EFSF/EFSM lending terms has therefore de facto been abandoned. The differences in lending terms between the EU instruments and the IMF makes the ESM as the successor to the EFSF, a much more attractive lender than the IMF for any future programme with exceptional access, particularly for large outstanding amounts. ⁽⁶²⁾ These differences are also not fully aligned with the G20 principles for cooperation between the IMF and regional financing arrangements ⁽⁶³⁾, which foresee consistency of lending conditions to the extent possible, in order to prevent arbitrage and facility shopping.

The set-up and operation of both the EFSM and the EFSF represented a major part of the added value of EU-level intervention. This is demonstrated by the significant spread between the average 10 year yield of the EA countries' sovereign bonds and the 10 year yield of the bonds issued by the EFSM and the EFSF (see Graph 4.2). ⁽⁶⁴⁾ Tapping financial markets at the EU/EA level rather than relying on bilateral loans allowed Ireland to benefit from financial assistance at a very low cost once the interest rate margins were removed. This was possible because the EFSM is guaranteed by the EU budget, while the EFSF was supported by the explicit, irrevocable and unconditional guarantee of each Member State to back the issuance for up to 165% of its stake. The two facilities were originally assigned AAA rating, despite the high market volatility at the time. ⁽⁶⁵⁾ ⁽⁶⁶⁾

⁽⁵⁹⁾ Initially, the carrying costs for IMF loans (flexible rate and surcharge) were lower than for fixed-rate EU loans. But the Irish authorities decided to hedge the foreign currency exposure which equalised lending rates between the two institutions.

⁽⁶⁰⁾ From 12.5 to 19.5 years for EFSM loans and from 15 to 22 years for EFSF loans. This extension should also increase the period under which Ireland will be under Post-Programme Surveillance (PPS). This should normally run until 75% of the assistance has been paid back.

⁽⁶¹⁾ The request required approval of both the EUROGROUP/ECOFIN (12 September 2014), the EFSF's Board of Directors and the IMF board.

⁽⁶²⁾ ESM lending rates have very small interest margins on top of the cost of funding and operations by the ESM. For detailed information concerning the pricing of ESM stability support instruments, see 'ESM Pricing Policy', <http://www.esm.europa.eu/pdf/Pricing%20guideline.pdf>

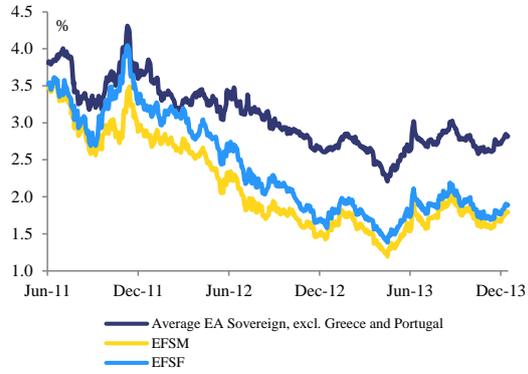
⁽⁶³⁾ As endorsed by G20 Finance Ministers and Central Bank Governors, 15 October 2011.

⁽⁶⁴⁾ Average is weighted for the GDP of each country. Smaller countries with a weight less than 1% are not included. Ireland, Portugal and Greece are also not included.

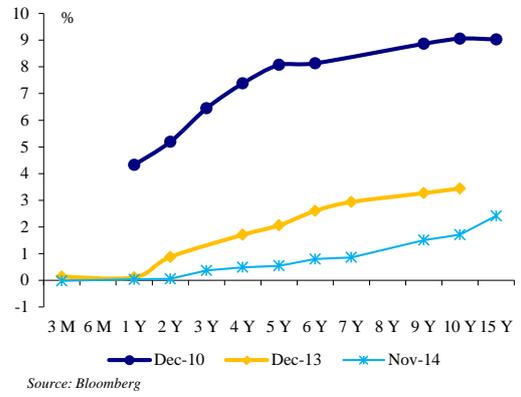
⁽⁶⁵⁾ Shortly after the change of France's long term rating from Aaa to Aa1 in November 2012, Moody's also downgraded the rating of the EFSF to Aa1 and maintained the negative outlook. Since the 6th of June 2014, the outlook is stable. By contrast, the EFSF continued to be assigned the best possible long-term by Fitch (AAA) and the best and short-term credit rating by Fitch and Moody's, <http://www.efsf.europa.eu/mediacentre/news/2012/2012-37-esm-and-efsf-statement-following-moodys-rating-decision.htm>

⁽⁶⁶⁾ In June 2014, Moody's stabilised the outlook on the Aa1 rating of the EFSF due to a change in the default correlation assessment, https://www.moodys.com/research/Moodys-stabilizes-outlook-on-the-Aa1-ratings-of-ESM-and-PR_300813

Graph 4.2a: Comparison of 10-year bond yields



Graph 4.2b: Evolution of Irish sovereign yield curve



5. FINANCIAL SECTOR POLICIES

5.1. KEY CHALLENGES AND PRIORITIES IN FINANCIAL SECTOR REPAIR

The main focus of the programme measures was rightly on repairing the Irish banking sector. The domestic banking sector was at the epicentre of a financial crisis that eroded the creditworthiness of the Irish government, put sovereign debt sustainability at risk and jeopardised long-term growth. As a consequence, the policies in the programme focused on repairing the Irish banking sector by winding up insolvent banks, enhancing the resilience of viable financial institutions and beefing up the supervisory and resolution framework. This implied a substantial overall downsizing of the sector, and of the remaining banks' balance sheets. A successful deleveraging would not only enable the return of financial stability without further recourse to public support, but also benefit the overall rebalancing of the Irish economy, paving the way to sustainable growth.

The Irish authorities' actions prior to the programme proved inadequate and reinforced the negative feedback loop between banks and the sovereign. When the programme started, the credit institutions ELG scheme was covering more than half of the unsecured senior debt of domestic banks, hence limiting the potential for burden sharing measures.⁽⁶⁷⁾ Moreover, the newly established NAMA – a "bad bank" mainly created for the purpose of acquiring property development loans from Irish banks in return for government guaranteed bonds – was already buying up non-performing assets from ailing domestic banks, mainly Anglo, INBS, and Allied Irish Banks (AIB) (see Table 5.1). In total, the Irish government had injected €46 billion into the domestic banks by end-2010, of which €34.7 billion had been provided to Anglo/INBS alone, mostly through some €31 billion of promissory notes. As a result, the government became a majority shareholder of AIB, EBS Building Society (EBS) and INBS. It had decided to nationalize Anglo outright. This left Bank of Ireland (BOI) as the only privately-owned major domestic bank. However, the viability of the Irish banking sector remained uncertain, and it still relied to a large extent on government support. Confidence in the government's solvency was increasingly undermined by a deteriorating fiscal position and high uncertainty about the ultimate cost of banking sector support.

Table 5.1:

Key features of the major domestic banks in Ireland

	Anglo	INBS	BOI	AIB	EBS	ILP	TOTAL
Total Assets as of 2008 (€bn)	101	14	197	182	19	75	588
as percentage of Irish 2008 GDP	56%	8%	109%	101%	11%	42%	327%
Equity as of 2008 (€bn)	4.1	1.2	6.5	10.3	0.7	2.3	25
as percentage of 2008 assets	4.1%	8.6%	3.3%	5.7%	3.6%	3.1%	4.3%
Transfer to NAMA (Nominal Value, €bn)	34	8.5	9.3	19.6	0.8	-	72.3
as percentage of 2008 assets	34%	61%	5%	11%	4%	-	12%
Average discount	62%	64%	42%	54%	60%	-	58%
2009-10 Cumulative Gross Losses (€bn)	30	5.8	0.6	12.6	0.7	0.5	50
as percentage of 2008 equity	732%	483%	9%	122%	100%	22%	
2009-10 Gross Public Capital Injection (€bn)	29.3	5.4	3.5	7.2	0.9	-	46
as percentage of 2008 equity	715%	450%	54%	70%	129%	-	
Loan to Deposit (LTD) Ratio	217%	NA	152%	146%	167%	246%	

Sources: The Financial Measures Programme Report; Banks' annual reports; Bloomberg; State Aid Decisions, European Commission. Notes: Equity figures reflect financial statements without further reclassification; ILP data includes insurance operations. LTD ratio data refer to 2009, to avoid distortions potentially arising from disposal of loans to NAMA.

The bursting of the property bubble eroded the asset base of the Irish banking sector. In aggregate, domestic banks recorded losses of €50 billion (around 30% of GDP) in 2009-10, with dramatic consequences for their capital base (see Table 5.1). Particularly hit were banks such as Anglo and INBS which had large operations in commercial property lending and property development. However,

⁽⁶⁷⁾ The ELG scheme provided State guarantees on newly issued debt (with maturity up to five years) for Anglo, INBS, AIB, EBS, BOI and Irish Life and Permanent (ILP). ELG replaced the original Credit Institutions (Financial Support) (CIFS) scheme.

aggregate bank deleveraging from 2008 to 2010 had been very limited and the banks' assets were still concentrated on property loans.

When their risky funding models collapsed, the banks relied on liquidity provided by the Eurosystem. The banks had increasingly relied on wholesale funding implying very high LTD ratios (see Table 5.1). When global risk aversion surged as a result of the worldwide financial turmoil in 2008 and uncertainty about the magnitude of losses prevented investors from distinguishing between viable and non-viable credit institutions, funding markets dried up. The banks then sought support from the Eurosystem. Under the fixed-rate full allotment policy, as introduced in October 2008 in the main and long-term refinancing operations, the ECB fully satisfied the increasing demand for liquidity of Irish banks presenting eligible collateral. ⁽⁶⁸⁾ In addition, the CBI lent via ELA to domestic banks unable to present the ECB with eligible collateral. By the end of 2010, this liquidity support corresponded to around 20% of the domestic banks' aggregate liabilities. ⁽⁶⁹⁾ In the case of Anglo, the proportion was significantly higher (65%). However, extraordinary liquidity support is basically intended to overcome a short-term liquidity crisis and it should be limited to solvent credit institutions ⁽⁷⁰⁾. It was not a suitable instrument for tackling the structural problems in the Irish banking sector.

The banking supervision and resolution frameworks proved inadequate during the run-up to the crisis. Although some actions had already been taken by the Irish authorities, including re-integrating financial regulation into the central bank, the basic supervisory approach had not yet changed when the programme started. The Irish light-touch approach had led to a series of supervisory failures, such as (i) the non-intrusive style of supervision that depended on the internal risk assessments of banks and relied on a limited number of staff resources to supervise an ever growing banking system; (ii) a failure to address the rapid increase in mortgage lending by imposing sectoral caps on lending or loan-to-value ratios (LTV); ⁽⁷¹⁾ and (iii) a dependence on expectations of a soft landing to the housing bubble in stress tests and evaluations. ⁽⁷²⁾

Funding stresses on the government were exacerbated by macro-financial linkages and the negative feedback loop between banks and the sovereign. Borrowing and injecting considerable funds into non-viable banks worsened Ireland's fiscal position. Irish public debt had significantly increased in the two years before the programme (in part due to issuing the promissory notes, as discussed in Box 5.1). As a result, yields on Irish government bonds and hence sovereign funding costs soared. The Irish sovereign had therefore faced a dilemma prior to the programme. On the one hand, stabilising the financial sector required substantial additional resources. On the other hand, any further recourse to sovereign debt markets, if at all possible at this juncture, would have undermined fiscal sustainability.

Due to intensified negative feedback loops between banks and the sovereign, the programme had to deal with a number of fundamental trade-offs. The option of a substantial contribution from existing creditors to the bank recapitalisation was desirable per se as it would have limited the call on public finances. However, this had to be balanced against the significant risk that it could lead to negative spillovers and financial instability in Ireland and Europe. ⁽⁷³⁾ An aggressive private sector bail-in might

⁽⁶⁸⁾ The ECB's non-standard measures – Impact and Phasing-Out, July 2011. It has to be noted that ECB non-standard measures, such as the fixed-rate full allotment, were applied to the whole EA, with the aim of ensuring the appropriate monetary policy transmission mechanism, in accordance with the ECB mandate.

⁽⁶⁹⁾ Source: CBI Balance Sheet.

⁽⁷⁰⁾ "National legislations foreseeing the financing by national central banks of credit institutions other than in connection with central banking tasks (such as monetary policy, payment systems or temporary liquidity support operations), in particular to support insolvent credit and/or other financial institutions, is incompatible with the monetary financing prohibition" ECB Convergence Report 2008.

⁽⁷¹⁾ In 2006, the Financial Regulator increased risk weightings applying to residential mortgage loans (for the portion exceeding 80 per cent of the value of the property).

⁽⁷²⁾ See McGowan, M. A., 'Overcoming the banking crisis in Ireland', *Economics Department Working Paper*, No. 907, OECD, 2011.

⁽⁷³⁾ See also the speech by Jean-Claude Trichet at the conference "Ireland and Euro Area Governance: Past, Present and Future", as organized by the Institute of International and European Affairs (Dublin, 30 April 2015)

have benefited public debt sustainability, but it would probably not have provided the substantial funds needed for recapitalising the faltering domestic Irish banks in due time, as analysed in Section 5.2.2. By the same token, the advantages of a fast and comprehensive deleveraging and loan restructuring process had to be weighed against the fact that front-loaded banks' balance sheet clean-up implied higher capital needs and hence higher fiscal costs. Another trade-off related to the hierarchy of priorities in bank restructuring. Rapidly restoring the sustainability of the banks - at a time when financial stability was at severe risk - had to be weighed against ensuring adequate competition in the sector in the medium term.

5.2. CURING THE ILLS OF THE DOMESTIC BANKING SYSTEM

The stabilization of the Irish banking sector, and its eventual return to profitability, required a substantial downsizing and a prompt clean-up of banks' balance sheets. These were essential elements of the adjustment programme. Non-viable banks were wound up and their remaining assets liquidated. The viable part of the banking system was recapitalised. Programme requirements included a specific plan for the resolution of Anglo and INBS (identified as non-viable) and for the four remaining domestic banks to submit restructuring plans to the CBI for assessment. An upgraded PCAR and a new Prudential Liquidity Assessment Review (PLAR) were used to gauge the recapitalisation and deleveraging needs of each domestic bank over the programme (see Table 5.2). In this regard, front-loading in the provision of programme funds allowed early recapitalisations and strengthened the banks' capital base beyond regulatory requirements. This enabled them to cover potential losses over the programme period. ⁽⁷⁴⁾

The reform of banking supervision started early, while other elements related to financial sector governance were supposed to be implemented at a later stage of the programme. Legislation on special bank resolution regime was to be introduced in 2011 Q1, followed by legislation aiming at enhancing financial regulation and expanding the supervisory and enforcement powers of the CBI. In contrast, the reform of the personal debt (insolvency) regime and the setup of a central credit registry were only scheduled for 2012.

Table 5.2:

Irish domestic banks under the programme

	BOI	AIB	EBS	ILP	Total
Initial Deleveraging Plans					
Core deleveraging (€bn) (negative means growth)	2.6	-1.5	2.6	5.3	9
as a percentage of 2010 core loans	3%	-2%	18%	20%	
Non-core deleveraging (€bn)	30	20.9	2.3	10.4	63.6
as a percentage of 2010 non-core loans	77%	83%	100%	100%	
Total deleveraging (€bn)	32.6	19.4	4.9	15.7	72.6
as a percentage of 2010 total loans	28%	22%	30%	42%	
Recapitalization					
Needs					
Capital required 2011-13 pre-buffer (€bn)	3.7	10.5	1.2	3.3	18.7
Additional capital buffer (equity) imposed by the CBI (€bn)	0.5	1.4	0.1	0.3	2.3
Additional capital buffer (contingent) imposed by the CBI (€bn)	1.0	1.4	0.2	0.4	3.0
Sources					
Private equity raising	2.3	0.0		0.0	2.3
Liability Management Exercise (LME)	1.7	2.1		1.3	5.1
Public equity injection	0.2	11.1		2.3	13.6
Other Public injection (CoCos)	1.0	1.6		0.4	3.0
Total recapitalization (€bn)	5.2	14.8		4.0	24
Post PCAR pro-forma Core Tier 1 ratio	16.1	22.0		32.4	

Sources : The Financial Measures Programme Report, PCAR 2011 Review. Notes : for ILP, LME include €300million classified as "other" source. For more details on CoCos see related footnote

⁽⁷⁴⁾ See European Commission, 'The Economic Adjustment Programme for Ireland', *European Economy*, Occasional Papers, No. 76, February 2011, pp. 24, 41-42.

5.2.1. A three-pronged approach – Resolution, recapitalisation and restructuring

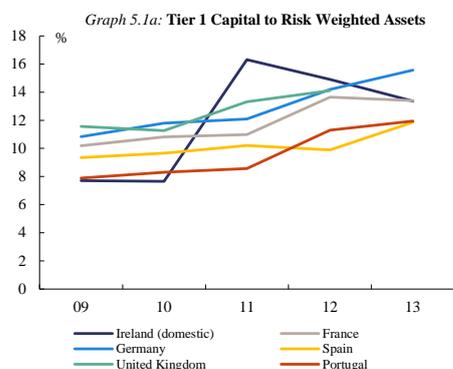
In March 2011, the Irish authorities announced a strategy for restructuring the domestic financial sector around two pillar banks. The strategy envisaged a system centred on BOI and AIB. ⁽⁷⁵⁾ BOI was the biggest domestic bank, with a relatively limited exposure to the property and construction sectors and limited losses. By contrast, AIB – the second biggest domestic lender at the time – was more exposed to the property and construction sectors. Anglo and INBS were to be liquidated. The Irish authorities decided to merge EBS with AIB because they had failed to get sufficiently attractive bids when they tried to sell EBS. ⁽⁷⁶⁾ While the intention was for Irish Life and Permanent's (ILP) insurance operations to be sold, at this time no decision was made on the strategy for the banking operations (Permanent TSB - PTSB). While both EBS and PTSB were relatively small corporate lenders, and had plans to withdraw from that business, they had a more important role in retail banking, notably in mortgage lending (with market shares of 17% and 10% respectively). PTSB did not transfer assets to NAMA; 90% of its loan portfolio consisted of residential mortgages which were not eligible as NAMA was only acquiring land and real estate development loans. However, €6 billion - or more than half - of the PTSB mortgage book consisted of loss-making tracker mortgages. This put the bank's future viability in question as losses from trackers were accruing over time. If PTSB's resolution had been pursued, these losses (and/or the extra-costs for financing its assets) would have crystallised upfront. The cost would have fallen on the State's shoulders, as European solutions for financing a bank in resolution were lacking at the time (see Boxes 5.1 and 5.2). Hence, PTSB was kept as a stand stand-alone bank.

Bank recapitalisations were able to restore investor confidence because they were based on reliable estimates of banks' capital needs. The recapitalisation process helped restore confidence in the solvency of the banks, enabling the pillar banks to regain access to debt markets in the course of the programme (see Box 5.3). Two elements that helped restore confidence stand out. The first was the rigorousness and transparency of the assessment of banks' capital needs. It entailed a top-down stress test, under the 2011 PCAR, and an extensive bottom-up loan loss assessment by an independent expert. ⁽⁷⁷⁾ Under PCAR, capital needs were calculated over a three year period, assuming a minimum Core Tier-1 target of 10.5% under the base case and 6% under the adverse macroeconomic scenario. The assessment of banks' capital needs also accounted for projected losses from disposals under the envisaged deleveraging process (as for 2011 PLAR). As a result of the independent loan loss assessment, additional buffers were added in the calculation of the capital needs to cover further potential loan losses after the three year programme period. The second key factor in the recapitalisation process was rapid implementation due to the timely provision of the required funds. In March 2011, aggregate recapitalisation needs were projected at €24 billion. This was significantly lower than the €35 billion estimate for financial sector support included in the programme financial envelope. The recapitalisations were completed by July 2011, lifting the aggregate Core Tier-1 ratio above the level of European peer banks and providing a substantial buffer for the adjustment process (see Graph 5.1a). At the end of the programme, the banks' aggregate Core Tier-1 ratios stood at around 13% and the buffers were preserved to some extent.

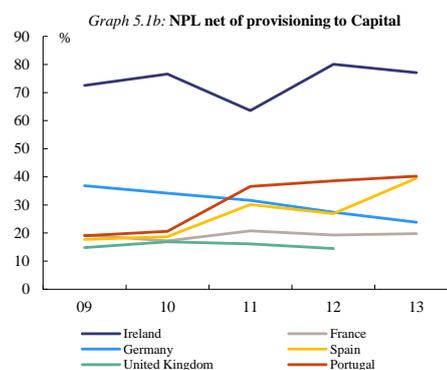
⁽⁷⁵⁾ Source: the announcement of the Minister of Finance of 30 March 2011, available at <http://www.finance.gov.ie/ga/news-centre/press-releases/minister%E2%80%99s-statement-banking-matters>.

⁽⁷⁶⁾ The merger was implemented after foregoing a bid from a consortium of private equity investors (including Cardinal Asset Management, the Carlyle Group and U.S. investor Wilbur Ross), submitted in January 2011, as not representing good value for the State.

⁽⁷⁷⁾ The loan assessment was independently performed by BlackRock Solutions (BlackRock) considering potential losses over the life time of the loan. The resulting losses were then converted into the three year horizon.



Source: European Central Bank



Source: IMF

The large upfront recapitalisation implied significant costs for the Irish sovereign. Out of the total of €24 billion needed for recapitalisations, the government provided €6.6 billion.⁽⁷⁸⁾ €5.1 billion was raised through Liability Management Exercises (LME), consisting of tender offers (buy-back) of subordinated debt securities at a discount of 70% (or more) of the nominal value.⁽⁷⁹⁾ Although LME limits the overall public capital injection, it is not equivalent to a full bail-in and/or bringing new shareholders on board. The remaining €2.3 billion represented fresh private capital injections into BOI. The €6.6 billion of capital injected by the government was a combination of equity (€3.6 billion) and contingent convertible notes (CoCos) (€3 billion).⁽⁸⁰⁾ The State managed to recover part (€2.9 billion) of its investment in BOI later in the programme.⁽⁸¹⁾

The option of inducing a stronger participation of private investors by providing adequate incentives was not implemented. In order to maintain the private investor base and/or attract additional private capital, the State could have temporarily foregone the voting rights on its shares. In addition, new shares placed with private investors could have been combined with warrants, enabling private shareholders to increase their stake by subsequently acquiring state-owned shares at pre-determined prices. The lower the pre-determined price, the higher is the incentive for the investors to participate in the recapitalisation, but also the higher the loss for the State. Such a scheme was not introduced in Ireland, because interest from private investors was minimal at that time. Investor concerns, fuelled by volatility in EA financial markets and uncertainty about the magnitude and timing of bank losses, were at peak levels. On balance, the costs of the incentives for private investors might have exceeded their potential benefits.⁽⁸²⁾

⁽⁷⁸⁾ Out of the €16.6 billion, the NPRF invested €10 billion, mostly in AIB, after selling €1 billion of its participation in BOI. Total public support to the banking sector during the programme amounted to slightly over €8.1 billion – after including €1.3 billion injected by the government to cover the sale of Irish Life (which was finalized during the programme allowing the State to recover that amount) and a further €0.3 billion disbursed in Q4-2012.

⁽⁷⁹⁾ The total amount generated by LME, prior to and during the programme (2009-2011), totalled some €4 billion. Source: ECB See: President M. Draghi reply to European Parliament question (QZ55-60). LME was conducted also with respect to the junior debt of Anglo and INBS.

⁽⁸⁰⁾ CoCos are subordinated loss absorption instruments, which contingently mandatorily convert into common equity or which contain contingent mandatory principal write-down features. Bearing a relatively high yield, CoCos have the benefit of incentivising the bank to redeem them.

⁽⁸¹⁾ This amount (€2.9 billion) came from the sale of €1 billion of CoCos and €1.9 billion of preferred shares. The issuance of the latter resulted from the government capital injection before the programme.

⁽⁸²⁾ Stakeholder consultation.

Box 5.1: A remedy to a hasty promise: the Promissory Note Transaction

In 2010/2011, there was no Irish nor EA/EU dedicated resolution framework and, hence, no established appropriate tools to cover uninsured deposits and Eurosystem funding for financial institutions under resolution in Ireland. The large size of the banking sector's balance sheet meant that potential costs, arising from the need to cover the depleted funding or the losses realized upon assets' disposal, were substantial. To avoid these costs that would have fallen on the State's shoulders, the Irish authorities had initially ruled out the outright liquidation of Anglo and INBS. ⁽¹⁾ However, to maintain their banking status, Anglo and INBS had to be adequately capitalized. Most of the capital injection from the State in the two banks was in the form of provision of promissory notes, which amounted to around €31bn, by the end of 2010.

The promissory notes consisted of IOUs (promise-to-pay) from the Government to the banks. They presented periodical payments (made of both a principal and an interest component) of €3.1bn p.a. from 2011 until 2023, decreasing thereafter and terminating in 2031. These payments would require a corresponding provision of funding by the Government and represented a burden for the State's financing needs, which had to be taken into account in both the financial sector and fiscal programme design. The promissory notes were not marketable and, hence, the banks could not sell them without agreement of the Government. Anglo and INBS were using them as a form of collateral to access ELA, for an amount estimated close to the notes notional. This helped them dealing with the reimbursement of over €7.5bn of matured senior debt (net of rolled-over) in 2010, before the programme started.

The programme envisaged the resolution of Anglo and INBS. In the first half of 2011, the two banks increased their dependence on ELA after having transferred almost all their remaining deposits and NAMA bonds to other Irish banks. In the second half of 2011, the two banks merged to form the Irish Bank Resolution Corporation (IBRC). The latter kept a banking licence and complied with the required capital level to remain solvent, thus retaining its access to the Eurosystem funding, by then almost exclusively in the form of ELA, to finance its remaining assets (mainly the promissory notes and a loan portfolio of around €20bn). ⁽²⁾ The repayment of ELA, whose outstanding amount was estimated at €40bn by the end of 2011, and the ensuing resolution of IBRC, relied on the payments to be received under the promissory notes and the outstanding loans and, hence, could have taken several years.

In early 2013, legislation was passed providing for the orderly wind-up of IBRC. ⁽³⁾ ELA was then closed in one go. See Graph 5.4. This was made possible by the CBI – which already had recourse to IBRC's assets as collateral under ELA – coming to directly hold around €25bn of newly issued long-term government bonds and almost €14bn of newly issued NAMA bonds, replacing the promissory notes and the outstanding loans, respectively. ⁽⁴⁾ This transaction (the "promissory note transaction") allowed to accelerate the resolution of IBRC, as the liquidation of the remaining loans was to be attributed to NAMA ("asset management company"), and the reduction of the immediate State financing needs, as the periodical payments of principal – including one of €2.6bn due in 2013 – were pushed back thanks to the replacement of amortizing notes with bullet bonds, with maturities of 25 to 40 years. ⁽⁵⁾

This transaction has however raised concerns of monetary financing. ⁽⁶⁾ Notwithstanding this, from an Irish perspective, it was the premise to solve the situation that the promissory notes had created. In particular, thanks to the replacement of non-marketable contracts, such as promissory notes, with marketable securities, such as government bonds, the transaction has given CBI the possibility to sell

⁽¹⁾ State aid NN12/2010 and C11/2010 (ex N667/2009) – Ireland, Second recapitalisation and restructuring of Anglo. In late summer 2010, however, the Irish authorities announced the plan to orderly wind-down Anglo.

⁽²⁾ Whelan, 2012. For an extensive analysis of this topic, see also Whelan, 2013, 2014.

⁽³⁾ Irish Bank Resolution Corporation Act.

⁽⁴⁾ This is in addition to c. €3.5 billion of a fixed-rate Irish Government bond, maturing in 2025. Source: CBI 2013 Annual Report.

⁽⁵⁾ When adding the interest component, the total payment scheduled in 2013 amounted to €3.1bn

⁽⁶⁾ The ECB 2013 Annual Report states that related "monetary financing concerns [...] could be somewhat mitigated by the [government bonds] disposal strategy of the Central Bank of Ireland". Minimum amounts to be sold are €0.5bn before end-2014, €0.5bn p.a. in 2015-18, €1bn p.a. in 2019-23, €2bn p.a. after 2023.

(Continued on the next page)

Box (continued)

the bonds in the markets, with the only constraint that the sale is not disruptive to financial stability, thus allowing the situation to normalize and contributing to Ireland's sustained re-access to financial markets.

Box 5.2: Locking in mispricing: the case of tracker mortgages

In Ireland, around 85% of mortgages were traditionally issued on a variable rate⁽¹⁾. More importantly, a large share of these mortgages had interest rates tracking the ECB base rate at an agreed margin (tracker mortgages). The most common alternative variable rate mortgages are Standard Variable Rate (SVR) mortgages, where the interest rate is set by the credit institution. The key difference between the SVRs and the trackers is that while credit institutions can adjust the interest rate charged on the SVRs over the course of the mortgage, the interest paid on trackers is the result of a fixed margin being applied to the ECB base rate. In Ireland, the vast majority of trackers had lifetime fixes.

During the boom years, tracker mortgages were granted when Irish banks were experiencing exceptionally favourable funding conditions. The banks were able to pass these conditions onto their customers by offering mortgages with very low interest rates. Tracker mortgages were used to finance both primary housing and investment properties ("buy-to-let") at similar interest rate levels. Almost 80% of trackers had a margin of 150 basis points or less. Given that the probability of a future increase in banks' funding costs was higher than the probability of a decrease, tracker margins should have been set higher. The CBI shows that until mid-2008, tracker mortgages had the same (or lower) interest rates than SVRs. This can be seen as systematic and prolonged mispricing by the Irish banks prior to the programme. As banks' funding costs increased, trackers became structurally loss-making. For the publicly owned banks, this entailed an implicit transfer of wealth from tax-payers to the holders of tracker mortgages.

A possibility for correcting this implicit transfer that was suggested at the time was a tax specifically designed for trackers' holders. The revenues from such a tax would have needed to be transferred directly to the banks. There were however legal and political questions over whether previous potential mispricing by banks of their products, embedded in legal contracts, could be remedied through fiscal policy. Although not addressing the issue of the implicit transfer, another way to mitigate the negative carry related to the trackers would have been to lower their funding costs.⁽²⁾ In the absence of EA-wide risk-sharing instruments, credit enhancement through some form of state support could have been introduced so as to increase the implicit "credit standing" of those legacy assets, hence facilitating their access to and reducing the cost of funding. Any of these potential means of mitigating the negative carry of tracker mortgages (based either on fiscal transfer or funding adjustment) would probably have entailed additional support to the banks and would have needed to comply with the EU State aid rules. By the end of the programme, none of these suggested solutions was implemented. However, the trackers' negative impact on profitability has now been mitigated by a general improvement in the banks' funding conditions.

⁽¹⁾ Source: Variable Mortgage Rate Pricing in Ireland, J. Goggin et al., 2012.

⁽²⁾ Negative carry identifies a situation in which the cost of holding an asset exceeds the yield earned. For a bank, the cost of holding an asset is a function of certain elements, such as the capital absorption and the cost of funding.

5.2.2. Potential bail-in of senior bondholders – Still a controversial issue today

Not bailing-in the holders of senior debt was motivated by concerns about triggering financial instability and jeopardising the overall success of the adjustment process. A bail-in could have been envisaged as an alternative - or complement - to bank recapitalisation by the State. As of February 2011, the senior unsecured and unguaranteed debt of all domestic banks ⁽⁸³⁾ amounted to €16.4 billion. ⁽⁸⁴⁾ Excluding BOI, where equity capital was not wiped out and fresh private capital was injected, lowers this amount to €1.2 billion. With a 50% haircut on that amount, ⁽⁸⁵⁾ the gross savings for the State would have been less than €6 billion. Potential additional costs arising from a decision to bail in could have exceeded that amount. A bail-in would have been a first case in a EA Member State. A number of important considerations were taken into account in not bailing-in senior creditors:

- In 2010-11, the legal context was unclear and the bail-in approach was untested. At that time there was no consensus on the principles to follow when introducing a bail-in framework. The Financial Stability Board only issued a list of principles in October 2011 and the EU developed a proposal in June 2012. ⁽⁸⁶⁾ Prompt recapitalisation was needed to restore market confidence and put the programme on a sound footing. The recapitalisation process was announced in March 2011 and broadly completed by July 2011. A bail-in would have required the introduction of ad hoc legislation, which had to be consistent with the very general legal principles of EU law, such as "non-discrimination" and "legitimate expectations". Even with the introduction of such legislation, litigation risks would have been very high and could have lasted for some time, casting a shadow on the programme's successes.
- The guarantee previously extended by the Irish authorities (ELG) effectively reduced the potential net savings for the State from implementing a bail-in. ⁽⁸⁷⁾ The ELG was covering €21 billion of the banks' senior debt in aggregate. In the case of a coercive burden sharing, ⁽⁸⁸⁾ bailed-in creditors could have claimed *pari passu* treatment with the guaranteed creditors. ⁽⁸⁹⁾
- A bail-in could have produced an immediate funding gap for the banks. In Ireland, senior bond holders had the same level of seniority as the holders of deposit accounts, although smaller deposits (up to €100,000) were covered by the deposit guarantee scheme. In a context of increasing deposit outflows, the implementation of a broad bail-in would have likely required capital controls. A coercive burden sharing could have been considered as a default. This would effectively have barred the bank from Eurosystem funding, which exceeded €70 billion (43% of GDP) at the time. ⁽⁹⁰⁾
- A bail-in might have triggered significant spill-over effects within the EA, since investors would expect similar procedures to be used in other countries. Contagion to other EA countries had the potential to impair the overall success of the Irish programme. For example, higher funding costs for EFSF/EFSM loans would have meant higher interest rates on financial assistance granted to

⁽⁸³⁾ Namely BOI, AIB, EBS, PTSB, Anglo and INBS. The junior bond holders of these banks were subject to LMEs. See section 5.2.1

⁽⁸⁴⁾ According to the CBI, in February 2011, unguaranteed and non-collateralised debt of the domestic banks stood at €3.7 billion for IBRC, €5.9 billion for AIB, €0.5 billion for EBS, €1.1 billion for ILP, €5.2 billion for BOI.

⁽⁸⁵⁾ A 50% haircut is discussed in "EU-IMF assistance to EA countries: an early assessment", Pisani-Ferri, Sapir, Wolff, 2013 and in the reply of the ECB President, M. Draghi, to the European Parliament question (QZ55-60).

⁽⁸⁶⁾ In accordance with the EU statement of 29 October 2010 and the G20 meeting in South Korea on 12 November, a potential bail-in of bank creditors was not to take place before 2013. The EU-wide rules were developed in a legislative proposal by the Commission for a bank recovery and resolution directive (COM(2012) 280 final).

⁽⁸⁷⁾ According to the CBI, in February 2011, guaranteed debt of domestic banks was €2.9 billion for IBRC, €6.1 billion for AIB, €1.0 billion for EBS, €4.7 billion for ILP, €6.2 billion for BOI.

⁽⁸⁸⁾ As opposed to a voluntary burden sharing, pursued through tender offers.

⁽⁸⁹⁾ A significant portion of the debt was governed by foreign law.

⁽⁹⁰⁾ Source: "The implementation of monetary policy in the EA: General Documentation on Eurosystem monetary policy instruments and procedures", as also mentioned by the ECB President M. Draghi in his reply to the European Parliament questions (QZ55-60), dated 17 February 2015.

Ireland⁽⁹¹⁾. Furthermore, potential investors could have lost interest in Irish bank assets. Moreover, contagion to other EA countries would have likely been amplified by the following elements:

- Expectations of coercive burden sharing were originally not fully priced-in, even for the main Irish banks. Senior unsecured and unguaranteed bonds of BOI and AIB were trading at a discount to their nominal value which did not exceed 20% and 30% respectively during the programme.⁽⁹²⁾ Such discounts are smaller than the ones to be expected if a bail-in had been fully priced in (see Box 5.3).
- Appropriate EA safeguards, such as a harmonized resolution framework, did not exist at the time.

The alternative of a burden sharing that only applied to Anglo and INBS senior creditors would have had only limited benefits, but risks would have remained substantial. An alternative to a broad bail-in could have been a selective burden sharing involving the senior debt of only non-viable banks, namely Anglo and INBS. This was the initial preference of the Irish authorities, and aimed to recover some of the public funds previously provided.⁽⁹³⁾ As of February 2011, the senior unguaranteed and unsecured debt of the two banks amounted to around €3.75 billion.⁽⁹⁴⁾ However, gross savings from a coercive burden sharing were expected to be lower than the notional amount. Net savings were uncertain, since the ultimate fiscal costs resulting from replacing Eurosystem funding⁽⁹⁵⁾ and counteracting contagion⁽⁹⁶⁾ and financial instability were likely to exceed the gross savings from the burden sharing. In addition to the above-mentioned litigation risks, a coercive burden sharing could have not been compliant with the creditors' ranking in a regular bankruptcy procedure.⁽⁹⁷⁾

In sum, burden sharing involving senior creditors would probably have accelerated deposit outflows and ultimately impeded the banks' return to private, non-guaranteed funding. This could have prolonged the banking sector's reliance on government support and possibly intensified the negative feedback loop between the banks and the sovereign.

5.2.3. The long arm of the crisis – Dealing with legacy assets

Breaking the negative bank-sovereign feedback loop required a rigorous clean-up of banks' portfolio of non-performing loans (NPL) and other legacy assets. The return on equity of the Irish domestic banking system remained negative throughout the programme. When compared with banks from other EA Member States, the key driver for Irish domestic banks' underperformance over the programme period has been the large asset impairment charges, which were mainly the result of the need to clean up their balance sheets (see Graph 5.2b). These impairment charges were driven both by the

⁽⁹¹⁾ EFSF and EFSM collected the funds on the markets gradually, starting from January 2011, and financed half of the overall external financial support to Ireland. Low EFSF/EFSM rates were possible because of the market confidence in the EA Member States ability to cross-guarantee EFSF and the EU budget guarantee (EFSM). In November 2011, when the EA sovereign average yield reached its peak (4.25%), the EFSF yield also reached its peak (4.0%) and the differential between the two reached the minimum (25bps), because of the higher implied priced-in risk of a joint default of EA countries. See section 4. A similar scenario could have been amplified and prolonged in case of contagion in the financial sectors across Europe, triggered by a bail-in.

⁽⁹²⁾ With the exception of 28 business days in the case of AIB.

⁽⁹³⁾ Prior to the programme, the government injected about €35 billion into Anglo and INBS.

⁽⁹⁴⁾ A portion of the debt was held by Irish banks and credit unions. Another significant part was denominated in currencies other than euro, hence possibly held outside the EA. In more general terms, the conclusion that a significant portion of Irish bank debt was held outside the EA is also supported by the findings of Coates and Everett in 'Profiling the Cross-Border Funding of the Irish Banking System'.

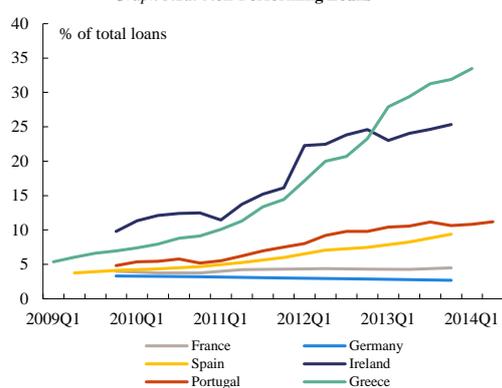
⁽⁹⁵⁾ A default and the subsequent exclusion from Eurosystem funding would have required to refinance up to €40 billion.

⁽⁹⁶⁾ See Speech by Jörg Asmussen, Member of the Executive Board of the ECB, at the Institute of International and European Affairs, Dublin, 12 April 2012 and ECB answers to the questions: "When the issue of burden-sharing of senior debt issued by Anglo Irish Bank was on the programme's agenda in late 2011, why did the ECB not support the bail-in of its remaining senior debt?" as outlined in <http://www.ecb.europa.eu/press/html/irish-letters.en.html>

⁽⁹⁷⁾ The creditors' ranking implies that all the capital has to be wiped out first or considered as lost, before senior creditors are to share the losses (on equal terms according to their ranking, taking into account presence of specific pledges).

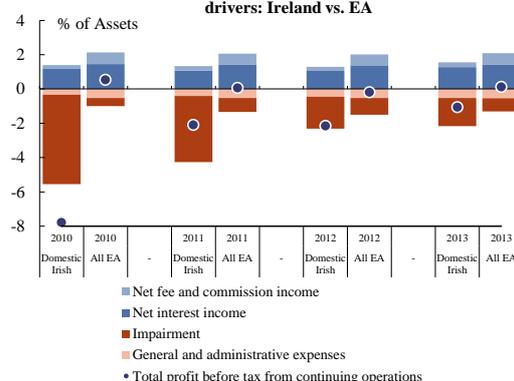
increasing provisioning for already existing NPL, and by the rise in NPL volumes. ⁽⁹⁸⁾ However, when the programme expired, the volume of remaining NPL was still substantial and write-offs had been limited. Operating profits of the Irish domestic banking sector as whole were also lower than for EA peers. In particular, besides the low interest income, revenues from commissions and fees were lower than the EA average, due to existing constraints for setting and changing bank charges. ⁽⁹⁹⁾ Strengthening the revenue stream could have helped to mitigate the losses deriving from provisioning charges. While the programme looked into the issue, it did not require the abolition of the barriers to increasing these charges. This was because, in the absence of a system of quasi-fixed charges, the risk of collusive behaviour in a de facto duopoly would have been high. ⁽¹⁰⁰⁾

Graph 5.2a: Non-Performing Loans



Source: IMF

Graph 5.2b: Comparison of key bank profitability drivers: Ireland vs. EA



Source: European Central Bank

Though important for the credibility of the programme, the upfront capital injections limited the incentives for banks to forcefully address their inefficiencies. Weaknesses in the restructuring plans of both AIB and PTSB were highlighted during the programme. These related to the need to strengthen revenue, reduce costs, further restructure operations and improve their ability to deal with mortgage arrears. ⁽¹⁰¹⁾ To incentivise banks to address their weaknesses and clean-up their balance sheets, disbursements of capital could have been gradual and tied to specific loan losses, up to the amounts that had been estimated ex ante under the asset review and PCAR/PLAR. This could have helped to accelerate the repair of banks' balance sheets and eventually to minimise the amount needed for capital support. Potential market concerns over whether capital injections would have been available when needed could have been countered by allocating the financial sector-related programme funds to a special fund, responsible for providing capital support and steering the restructuring process. Moreover, such a scheme would have helped increase accountability on the use of the funding envelope, intended for the banking sector.

The high and increasing NPL ratio represented a considerable burden for the banking sector. Given that impairment losses are often recognised too slowly under current accounting standards, ⁽¹⁰²⁾ the CBI introduced provisioning guidelines early in the programme. This improved the standards for

⁽⁹⁸⁾ Only recently, the Irish banks reached more adequate levels of coverage of non-performing assets with impairment reserves (of around 50%).

<http://www.bankofireland.com/fs/doc/publications/market-news-and-analysis/boi-web-results-presentation-june-2014.pdf>

⁽⁹⁹⁾ Within the EU, Ireland is unique in regulating bank charges. Under Section 149 of the Consumer Credit Act 1995, Irish banks must make a submission to the CBI if they wish to introduce a new charge or increase charges for an existing service. In that case, they must provide a statement of the commercial justification for the proposal, including a detailed statement of cost as well as details of the estimated amount of additional income accruing from the proposal. The CBI can reject proposals for a number of reasons, including the impact new charges or increases in existing charges will have on consumers.

⁽¹⁰⁰⁾ Stakeholder consultation.

⁽¹⁰¹⁾ Economic Adjustment Programme for Ireland Spring 2012 Review, Occasional Papers 96 | June 2012, Economic and Financial Affairs.

⁽¹⁰²⁾ See also Gaston, E. and I. W Song, 'Supervisory Roles in Loan Loss Provisioning in Countries Implementing IFRS', *IMF Working Paper* 14/170, September 2014.

recording prospective loan losses. However, it was only in 2013 that targets for banks to restructure loans in arrears were introduced, with a final date of implementation set for end-2014. ⁽¹⁰³⁾ In light of the lengthy process of setting up appropriate operational frameworks to deal with mortgages in arrears, the targets on restructuring could have been introduced earlier, together with the elimination of legal constraints to writing-off uncollectable loans. ⁽¹⁰⁴⁾ The targets could have been combined with a more timely reform of the insolvency framework (see section 5.2.5). An earlier and more rigorous clean-up of balance sheets could have given banks a head start, allowing them to stimulate lending and facilitate their re-privatisation process.

The programme maintained the structure of NAMA. This proved beneficial for banks' deleveraging, and contained losses for the Irish State. By using a centralised asset protection scheme, banks effectively reduced the burden of legacy assets and strengthened their deleveraging and recapitalisation process. NAMA was well placed to manage and liquidate the acquired assets, which were clearly defined, limited in size and relatively easy to sell. The prices at which banks transferred the assets to NAMA were in line with the underlying economic value of the assets. ⁽¹⁰⁵⁾ A centralised entity like NAMA offered further specific advantages, such as economies of scope and specialised professional management. In addition, the joint private/public ownership structure kept NAMA relatively free of political interference. ⁽¹⁰⁶⁾ Finally, NAMA's funding was ensured by financial institutions, which sold their loans and were compensated with ECB-eligible NAMA bonds. NAMA first sold assets located in the UK, whose valuations were generally higher than for assets located in Ireland. By the end of the programme, NAMA had liquidated more than 30% of project assets (worth €1 billion), of which only 20% were located in Ireland, and redeemed 25% of senior bonds (€7.5 billion). NAMA was profitable for three consecutive years, despite recognising sizeable additional impairment provisions. Deleveraging targets under PLAR did not include the €70 billion of "land and real estate development" loans already transferred to NAMA.

The ambitious bank deleveraging process included proper safeguards and was managed in a flexible way. It was effective in downsizing banks' balance sheets and reducing their funding gap. ⁽¹⁰⁷⁾ Under PLAR, banks were initially required to achieve a LTD target of 122.5% by the end of the programme. To achieve this, workable plans for the amortisation and disposal of bank assets were put in place, together with safeguards to avoid fire sales. These plans envisaged aggregate deleveraging of over €70 billion, corresponding to around 45% of Irish GDP, over the programme period. The plans were subsequently marginally adjusted following the decision not to transfer loans of less than €20 million to NAMA. By the end of 2011, 40% of the required deleveraging had taken place, albeit with some differences across banks. In mid-2012, the target for the LTD ratio (122.5%) was dropped. This decision was based on the experience during 2011, when banks' competition for deposits was driving up interest rates to unsustainable levels. The LTD target was replaced with targets on nominal non-core deleveraging. In aggregate, deleveraging was complete by the end of the programme. The banks sold €45 billion of assets during the programme.

By liquidating mostly non-core foreign assets, Irish banks were left with less profitable domestic businesses. Non-core assets and businesses that did not offer clear synergies with banks' core activities

⁽¹⁰³⁾ The "Impairment Provisioning and Disclosure Guidelines" were also revised in 2013 to (i) include a shifting emphasis from collateral to the borrower's creditworthiness assessment, when determining provision requirements, and to (ii) ensure proper recognition of problematic loans under restructuring.

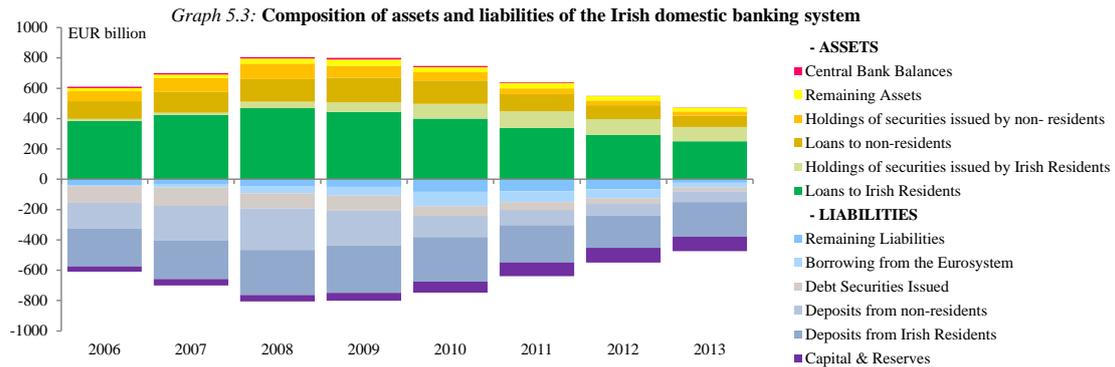
⁽¹⁰⁴⁾ Targets on loans to be restructured should be applied uniformly across banks to avoid discrimination across borrowers.

⁽¹⁰⁵⁾ Loans were sold at their "long-term economic value", which resulted in higher prices than market value.

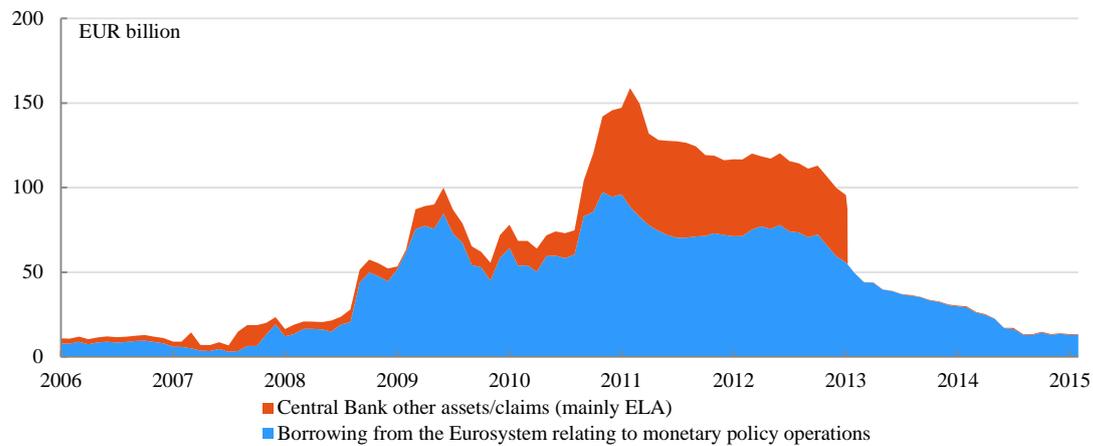
⁽¹⁰⁶⁾ NAMA is structured in such a way that its debt is not treated as part of Ireland's General Government Debt under European accounting rules. In order to avail of this accounting treatment, NAMA established an investment holding company – National Asset Management Agency Investment Ltd – which is majority-owned by private investors: 51% of its shares are owned in equal proportion by three private companies and the remaining 49% are owned by NAMA. However, under the shareholders' agreement between NAMA and the private investors, NAMA can exercise a veto over decisions taken by the company. The entity is highly leveraged and at its inception its capital amounted to only €100 million.

⁽¹⁰⁷⁾ A medium-term objective of deleveraging was also to ensure convergence to Basel III liquidity standards.

mainly consisted of foreign assets. Their disposal allowed a rapid reduction of foreign assets and liabilities. The liquidation of profitable foreign assets helped contain losses and limited the need for new capital, as required by EU State aid rules, but it constrained banks' future profitability. With hindsight, it might have been beneficial to liquidate more domestic assets. ⁽¹⁰⁸⁾ In particular, extending the NAMA scheme to other loans with a notional below €20 million, as initially envisaged in the programme conditionality, would have likely contributed to a faster repair of banks' balance sheets. ⁽¹⁰⁹⁾



Graph 5.4: Eurosystem exposure to Irish banking system



The side effects of deleveraging on new lending were mitigated by the specific targets on lending to SMEs agreed by AIB and BOI. ⁽¹¹⁰⁾ The cumulative revised lending targets amounted to €21 billion over the programme period. Further initiatives to support funding to viable businesses through a number

⁽¹⁰⁸⁾ PCAR Review shows that, as of June 2012, the banks "have performed better than expected in terms of deleveraging losses taken to date (c.€3.4 billion) compared to the €0.8 billion and €3.2 billion assumed in the PCAR base and stress cases respectively" [...][...]. In the occasion of the IMF-CEPR-Central Bank of Ireland Conference, held on 19 Jan 15, Governor Patrick Honohan confirmed that the deleveraging was achieved with lower costs than projected in March 2011.

⁽¹⁰⁹⁾ Total amount of sub-€20mln notional loans possibly eligible for NAMA had been estimated up to €16 billion. Source: The Economic Adjustment Programme for Ireland, Occasional Papers 76| February 2011, DG ECFIN.

⁽¹¹⁰⁾ Already since 2009, the Irish Government put emphasis on ensuring flow of credit to viable businesses, especially SMEs. To this end, under the NAMA legislation, a Code of Conduct on SME Lending was introduced and the Credit Review Office (CRO) was created. The latter was intended to facilitate credit mediation through reviewing rejected credit applications upon appeals from SMEs.

of state support schemes were gradually introduced later on. ⁽¹¹¹⁾ These schemes had mixed success. There was a better take-up rate for those targeting the provision of credit and equity, introduced only in 2013. The lack of success of previous schemes can be explained by SMEs' lack of awareness, and their inability to handle application procedures. ⁽¹¹²⁾ To ensure a bigger impact in the future, SME funding initiatives should include earlier and greater efforts to increase their accessibility. This lesson has been taken on board by the Irish authorities in recently implemented initiatives, funded from additional resources from European and national business development banks, which have become available after the programme terminated. ⁽¹¹³⁾

5.2.4. Bank restructuring in light of competition concerns

The programme attempted to preserve an adequate level of competition in the Irish banking sector. While the initial restructuring plan for BOI was quickly approved under State aid rules, plans for AIB and PTSB raised concerns about the banks' long-term viability. ⁽¹¹⁴⁾ Subsequently, AIB took time to revise its restructuring plan as it was about to integrate EBS. ⁽¹¹⁵⁾ Since foreign-owned banks were reducing their market presence in Ireland, the European Commission expressed concerns that the Irish banking sector could become a duopoly after the merger of EBS with AIB. The decision to maintain PTSB as a separate entity was motivated both by these concerns and the need to minimise the fiscal costs potentially rising from the bank's liquidation. As EBS effectively exited the market, ⁽¹¹⁶⁾ PTSB was expected to challenge the dominant role of the two pillar banks. This strategy has not yet been successful since the Irish banking system remains highly concentrated. ⁽¹¹⁷⁾ Not merging EBS with AIB could have facilitated the restructuring of AIB, and could have provided another means to foster competition. ⁽¹¹⁸⁾

The process of restructuring PTSB was protracted and complex; additional public support risked worsening Ireland's fiscal position. Not resolving PTSB initially helped to contain the fiscal costs for the State and preserve the financial stability of the Irish banking sector. However, deleveraging and restructuring proved slower for PTSB than for other banks. ⁽¹¹⁹⁾ The second draft of PTSB restructuring plan, submitted in June 2012, envisaged splitting the bank into three business units. A major stumbling block was the uncertainty about the set-up and funding of the proposed asset management unit (AMU), which was intended to acquire most of the loss-making trackers and to function as a bad bank.

⁽¹¹¹⁾ In 2012, two lending schemes were introduced to facilitate SME financing: Microfinance Ireland and Temporary Loan Guarantee Scheme. At the beginning of 2013, a further provision of funding to SME from the NPRF – in partnership with private investors – started to target credit, equity and turnaround financing.

⁽¹¹²⁾ Stakeholder consultation.

⁽¹¹³⁾ Also following up on the "High Level Expert Group on SME and Infrastructure Financing", in the second half of 2014, the Irish authorities created the Strategic Banking Corporation of Ireland (SBCI), which pools funds mainly from NPRF, the European Investment Bank (EIB) and the German state-owned business development bank (KfW) and distributes it through the banking networks. In May 2014, Irish authorities also launched an online campaign to increase awareness of available financing resources, named "Supporting SMEs".

⁽¹¹⁴⁾ Among other operational changes that could have explained some of the initial delays, there was the need to provide for an alternative deleveraging path to accounts for dropping the plan of transfer of loans of below €20m notional to NAMA.

⁽¹¹⁵⁾ The restructuring plan of AIB merged with EBS was approved in May 2014. The restructuring plan of PTSB was approved in April 2015. Recently, the State aid rules have been changed, so that recapitalisation of a bank with public funds cannot take place before the restructuring plan is approved. This has significantly improved the incentives for prompt finalisation of the restructuring plan from the side of the bank and the national authorities. See Communication from the Commission of 10.07.2013 on the application, from 1 August 2013, of State aid rules to support measures in favour of banks in the context of the financial crisis.

⁽¹¹⁶⁾ Initially, Irish authorities deemed an independent EBS necessary to ensure competition in the Irish mortgage and savings market, see EC decision on restructuring of EBS of 11 October 2010, available at: http://ec.europa.eu/competition/elojade/isef/case_details.cfm?proc_code=3_C25_2010.

⁽¹¹⁷⁾ While the level of competition in the Irish banking market does not appear worse than in other programme countries (notably, Cyprus, Greece) if measured by the cumulative share of the 5 largest credit institutions in total assets, the situation changes when measuring the market power of two largest credit institutions in terms of new lending, which represent some 70% of the banking sector in terms of domestic loans.

⁽¹¹⁸⁾ Dirk Schoemaker discusses the alternative possibility to merge EBS and PTSB into a combined bank, which could have turned into an affective challenger of the two larger banks. "Stabilising and Healing the Irish Banking System: Policy Lessons" (2015)

⁽¹¹⁹⁾ By the mid-2012, PTSB achieved only €0.8 billion of its non-core deleverage plan, i.e. less than 10% of the total targets. LTD ratio stood above 190%. By the end of the programme, LTD ratio remained above 150%.

The IMF stressed the need to have a timely and complete carve-out of the assets of AMU, and wished additional ECB or EU funding support. ⁽¹²⁰⁾ In the absence of EU-wide tools and frameworks for risk sharing, further support could not be provided by the ECB/EU and, hence, had to come from domestic sources. The European Commission examined the legal feasibility of options to improve the overall profitability of the tracker mortgages without negatively affecting the fiscal position of the State, but no solution was finally found (see Box 5.2). ⁽¹²¹⁾ In the end, the risk to the public debt sustainability from additional public support to PTSB was considered too high. Further public support to PTSB was not provided, and the carve-out of the trackers was not implemented. ⁽¹²²⁾

5.2.5. Enhancing the bank supervisory and the insolvency framework

Reforms to banking supervision aimed to reinforce prudential oversight and enhance the resilience of the banking sector. In 2011, the CBI introduced a new risk-based supervision system under which the level of supervisory engagement is proportional to the potential threat of a financial entity to financial stability. In 2013, the CBI was provided with further supervisory powers to conduct investigations, take direct remedial actions and enforce compliance by banks. ⁽¹²³⁾ In October 2011, a special Irish resolution regime was established for orderly wind-down of banks, requiring the set-up of a special fund to allow "bridge financing". The CBI was then required to create an independent resolution function and was empowered to establish "bridge banks" to temporarily hold assets in resolution. ⁽¹²⁴⁾ From the start of 2015, this regime remains applicable to the Credit Unions and no longer to the banks that are covered by the Bank Recovery and Resolution Directive (BRRD). ⁽¹²⁵⁾ This new regime should serve as a proper framework for an orderly bail-in, if needed in future. It would maximise benefits and minimise costs, ⁽¹²⁶⁾ having provided time to market players to adapt to the changes. It should reduce moral hazard - which the bank bail-outs did not directly address - with a positive effect on the robustness of the banking sector.

An earlier introduction of the reform to the insolvency framework would have facilitated deleveraging. Historical experience shows that debt restructuring can help to avoid harmful "evergreening" practices, which can lead to years of sluggish or depressed growth in a context of extended debt deleveraging. ⁽¹²⁷⁾ Debt restructuring can happen through a regular dialogue between the borrower and the lender, if the appropriate incentives are in place. However, such negotiations and their outcome ultimately rely on the effectiveness of (pre-) insolvency frameworks in place. These ensure that funds are channelled to solvent economic actors, and define the terms and conditions for entrepreneurs and households to make a fresh start. In Ireland, the new insolvency framework legislation was adopted at the end of 2012 ⁽¹²⁸⁾. The law envisaged the formation of a national insolvency service (Insolvency Service of Ireland, ISI). Specialist judges were to be appointed, and mandatory intermediaries and personal insolvency practitioners were to be authorised by the ISI. In practice, the implementation of the reformed personal insolvency regime started in November 2013. The first results were delayed until 2014 (after the end of the programme). While reforms to debt regimes take time to be designed and implemented, significant work had already been accomplished by the Irish authorities prior to the

⁽¹²⁰⁾ Source: IMF Country Report No. 12/147, pages 20 and following.

⁽¹²¹⁾ Stakeholder consultation.

⁽¹²²⁾ In 2013, PTSB managed to issue residential mortgage-backed securities of €500 million. A third draft restructuring plan was submitted in August 2013 and a final version was submitted after the Comprehensive Assessment in October 2014.

⁽¹²³⁾ The Central Bank (Supervision and Enforcement) Act 2013

⁽¹²⁴⁾ Central Bank and Credit Institutions (Resolution) Act 2011

⁽¹²⁵⁾ See Bank Recovery and Resolution Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council, <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0059&from=EN>

⁽¹²⁶⁾ Under the Single Resolution Mechanism (SRM), which applies the substantive rules of the Bank Recovery and Resolution Directive (BRRD), proper safeguards at EA levels have been introduced, entailing financing of banks under resolution through bail-in of shareholders and creditors and further recourse to funding provided by the banking system.

⁽¹²⁷⁾ See Mian and Sufi 2014; Bank for International Settlements, Annual Report 2012, 24 June, in particular pages 32 and 42.

⁽¹²⁸⁾ Ireland's Personal Insolvency Act.

programme.⁽¹²⁹⁾ Therefore, quicker adoption of the reform would have been desirable, or at least a roadmap setting out the intermediate steps to the adoption of the legislation.

The new personal insolvency framework is based on a broad political consensus, which balanced the interests of debtors and creditors.⁽¹³⁰⁾ Besides reforming the bankruptcy provisions, three new voluntary arrangements between debtors and creditors were introduced to encourage settlements to be made without recourse to court-based bankruptcy proceedings.⁽¹³¹⁾ One of the main features of the reform was to reduce the recourse to the borrower's income. This should encourage banks to lend more responsibly in the future. The personal debt regime framework was designed to also limit opportunistic behaviour on the borrower's side.

The new framework has increased the use of insolvency procedures, but is characterised by high costs and relatively complex processes. The number of applicants has been lower than the Irish authorities expected. The framework therefore did not succeed in reducing household arrears.⁽¹³²⁾ The low take-up could be attributed to certain design features.⁽¹³³⁾ Firstly, the choice of a voluntary scheme significantly narrows the scope for the adjustment, as opposed to mandatory reduction of recourse for mortgage loans based on pre-determined benchmarks (for example LTV or third party estimated liquidation value of the collateral). Secondly, newly introduced voluntary arrangements, while shielding primary residence from forced sale, do not allow discharge of secured (mainly mortgage) debt at the end of the arrangement unless creditors agree otherwise. In this respect, the reformed insolvency process does not help to achieve a quick balance sheet clean-up and undermines the incentives of the borrowers to apply for the arrangements. Thirdly, the procedures still have relatively high costs.⁽¹³⁴⁾ This is related to the lack of progress in respect to bringing down high Irish legal costs (see Chapter 7).

The introduction of the Central Credit Registry has been postponed. One reason for the delay was the need to accommodate changes to the personal public service number (PPSN), which is a key aspect of credit registers across Europe. An adequate credit information system is likely to increase lending, improve banks' credit appraisal and provide the regulator with more timely and reliable information on potential risk clustering.

5.2.6. Assessment

The programme was instrumental in restoring financial sector viability and investor confidence. Overall, banks' profitability has improved as the burden of legacy costs has been waning⁽¹³⁵⁾ and the share of low-yielding assets has declined, while the macroeconomic environment has improved

⁽¹²⁹⁾ See final report of the Mortgage Arrears and Personal Debt Group of 16 November 2010 and the final report on Personal Debt Management and Debt Enforcement of the Law Reform Commission of December 2010. Notably the latter already included an important recommendation of automatic discharge from bankruptcy after 3 years, subject to, amongst others, ordering the bankrupt make repayments for up to 5 years. It also contained a draft Personal Insolvency Bill.

⁽¹³⁰⁾ See Claessens, Stijn. Systemic Bank and Corporate Restructuring Experiences and Lessons (Worldbank).

⁽¹³¹⁾ Debt Relief Notices (DRNs), Debt Settlement Agreements (DSAs) and Personal Insolvency Arrangements (PIAs). DRNs apply to debtors with unsecured debts of up to €20,000. DSAs apply to unsecured debt of any value over €20,000. PIAs tie in secured and unsecured debt (nominally the secured debt only up to a limit of €3million, but the limit can be lifted with creditor agreement).

⁽¹³²⁾ For instance, while more than 37,000 borrowers have been in arrears for over two years, only 448 individual bankruptcies were recorded in 2014, against initial expectation of around 3,000 from the Irish Government. Sources: Insolvency Service of Ireland, Statistics Quarter 4 2014;

<http://www.irishexaminer.com/business/features/sluggish-start-to-insolvency-legislation-304537.html>;

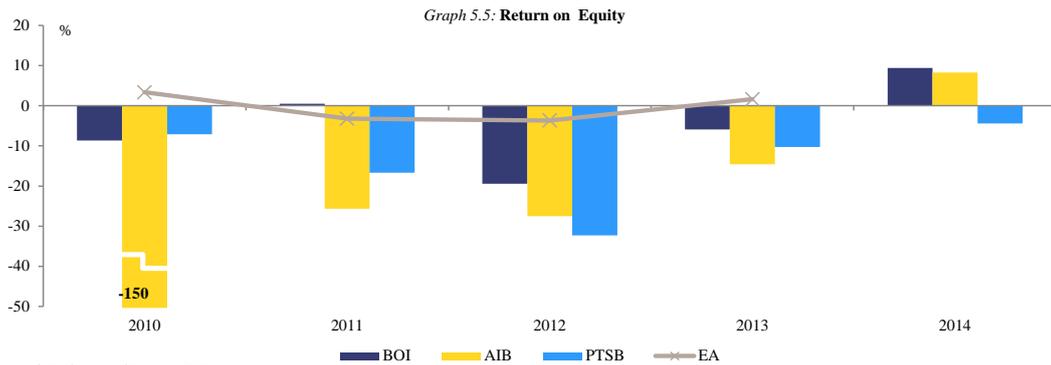
<http://www.ashfords.co.uk/irish-personal-insolvency-reform/>.

⁽¹³³⁾ There are indications that banks continue to rely heavily on legal proceedings in concluded solutions as a way of convincing customers in arrears to engage with them. The courts system is experiencing some backlogs, as shown by the more frequent adjournments and prolonged proceedings. Source: Country Report Ireland 2015, including an In-Depth Review on the prevention and correction of macroeconomic imbalances, EC staff working document.

⁽¹³⁴⁾ High costs are also the main negative element of the corporate insolvency framework, which is in place in Ireland and could be considered otherwise a relatively efficient regime (quick and with a high recovery rate). Source: World bank, Doing business 2015 – Resolving insolvency.

⁽¹³⁵⁾ For example, ELG fee payments have reduced significantly as total liabilities covered under the scheme decreased.

significantly. Both BOI and AIB returned to profitability in 2014. PTSB is still incurring losses but its financial situation is also gradually improving. ⁽¹³⁶⁾ Further improvements in the banking sector will depend on the evolution of funding costs and a successful reduction of the NPLs, which although decreasing in 2014, still remain high. ⁽¹³⁷⁾ This in turn relies on the recovery of the domestic economy, the wider effects of the insolvency framework reforms, and the banks' approach to dealing with loans in arrears.

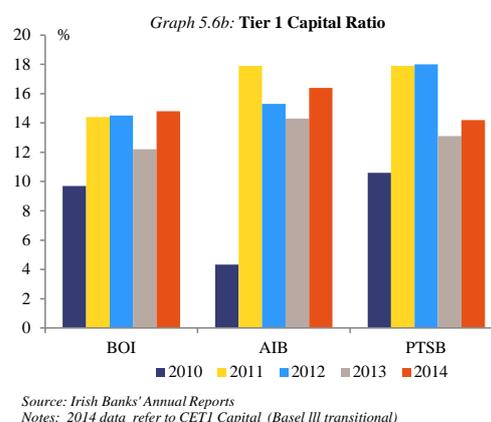
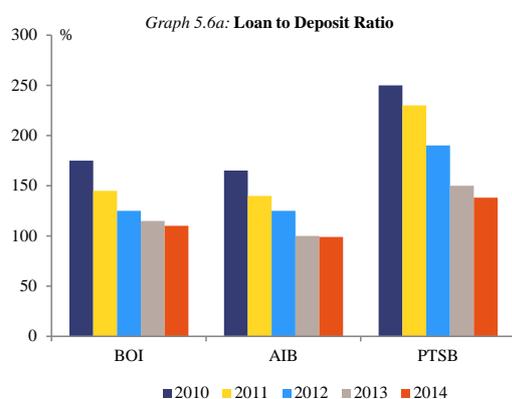


As a result of the programme, the Irish domestic banking system has become more resilient to external shocks. The size of domestic banks' balance sheets was reduced by more than 30%, (see Graph 5.3), thanks to a successful deleveraging process and the resolution of non-viable banks. However, as a side effect of the deleveraging process, Irish domestic banks have partly withdrawn from international business and focused more on the Irish market. Vulnerabilities in banks' funding structure have been addressed. Eurosystem funding to Irish domestic banks dropped below €40 billion by the end of the programme, and below €15 billion by the end of 2014. Funding pressures have been further eased by the two pillar banks' (BOI and AIB) ability to return to the debt markets by the end of the programme. The aggregate LTD has fallen to close to the initially targeted level of 122.5% (see Graph 5.6a). The banks' capital position has also been significantly strengthened (see Graph 5.6b). This notwithstanding, the ECB pointed to some vulnerabilities under the newly applicable capital requirements (CRD IV) in its 2014 comprehensive assessment. While PTSB has already been required to strengthen its capital base, the two pillar banks – AIB in particular – could face challenges in view of the phasing-in of stricter capital requirements in the medium-term, if they cannot generate sufficient profits on a sustained basis. ⁽¹³⁸⁾

⁽¹³⁶⁾ PTSB recorded an operating loss before exceptional items of €39 million in 2014 vs €77 million in 2013. The management does not expect the bank to become profitable before 2017 but successfully raised €25 million from capital markets in April 2015, through sale of €400 million of equity shares and issuance of Additional Tier 1 Capital of €125 million. Subsequently, the Irish government lowered its stake in PTSB to 75%.

⁽¹³⁷⁾ Aggregate public data on NPLs are not available yet for Q4 2014 and for 2015. Given the 2013 revision of the provisioning guidelines, an NPL cannot be cured before it is performing for twelve months, thus implying a commensurate lag between the loan curing and the NPL reclassification. In September 2014, all banks had met and exceeded the target of proposing and concluding sustainable restructuring solutions to mortgage holders in arrears. Also, the banks are making progress in reaching their restructuring targets for non-public commercial loan (including SME). However, there are still discrepancies in the way banks classify restructured loans, as there has been a reliance on standard forbearance techniques involving rescheduling rather than lowering principal or interest payments. Source: Country Report Ireland 2015, including an In-Depth Review on the prevention and correction of macroeconomic imbalances, EC staff working document.

⁽¹³⁸⁾ As part of its comprehensive assessment published in October 2014, the ECB estimated an applicable Common Equity Tier 1 (CET1) gap of around €800 million for PTSB under the adverse stress test scenario. Thereupon PTSB Group confirmed that it has already “provided for” over 80% of the identified shortfall thanks to progress made in 2014 and the Group's existing CoCos. In April 2015, the Group raised €25 million from the capital markets. Moreover, the EBA projected a capital ratio of 1.69% for AIB in 2016, based on a fully implemented CRR/CRD IV definition CET1 under the baseline scenario. However,



The supervisory structure of the Irish banking system is now more robust. Prudential oversight is likely to be less lenient in a future housing market boom. The Irish bank supervisory and resolution reforms define a robust framework for the credit institutions that do not fall under the immediate remit of the Banking Union and remain directly supervised by the CBI. The latter has significantly improved its standing and track-record, during the programme, as discussed in the previous sections. Moreover, under the European framework for macro-prudential regulation, as defined by the European Systemic Risk Board (ESRB), the CBI has recently introduced caps on Loan-To-Income (LTI) and LTV ratios for new residential mortgages. This attempts to contain credit growth in light of rising house prices. ⁽¹³⁹⁾

The still-limited success of the new insolvency framework in reducing the outstanding amount of NPLs suggests that balance-sheet repair is far from complete. Moreover, the implementation of the credit registry, and thus improvements to the credit information system, is not expected before the latter part of 2016.

Programme measures related to the financial sector were coherent with other EU policies. Policy measures aimed at stabilising the banks have been consistent with EU State aid rules. Beneficiary financial institutions were required to contribute to capital increases according to deleveraging plans, in order to minimise the distortion of competition. Similarly, the conditionality related to the supervisory reform and the bank resolution framework was already in line with the main features and principles that were later integrated in the developing Banking Union.

The design and monitoring of financial sector conditionality was based on a common understanding among Troika partners. Programme reviews, periodically published by the European Commission, in liaison with the ECB, and the IMF, do not suggest major differences with respect to the design and monitoring of financial sector conditionality. This view has been confirmed by stakeholders, who indicated that the three institutions have been able to build common ground with the aim of ensuring the success of the programme. Two exceptions stand out in this respect. Firstly, as regards the bail-in of senior bond holders in light of the legal uncertainty and the risks of spillovers to other EA countries, the ECB's point of view prevailed, supported by the European Commission, over the IMF. Secondly, with respect to the restructuring of PTSB, the IMF and the Irish authorities would have preferred additional funding from the ECB or EU. Also, the European Commission attended to its duties as competition authority, and did not grant a waiver on State aid rules in the PTSB case.

phasing in of CRR/CRD IV definition will not be terminated before 2019 and the baseline scenario was assuming significant losses in the three years ahead.

⁽¹³⁹⁾ See CBI, 'A Macro-Prudential Policy Framework for residential mortgage lending', Consultation paper CP87, 2014.

Box 5.3: The banks' successful return to the debt markets

With the expiry of the CIFS guarantee in September 2010, the yield of senior unsecured debt of AIB and BOI, issued before December 2009 and hence not guaranteed under the ELG, decoupled from the yield of government debt and rose above 10%. The banks' bond yield peaked above 15% in the second half of 2011, before gradually reducing to around 5% in 2012 Q4 and 2.5% by the end of the programme. (See Graph 1)

As set out in the graph and table below, the main events associated with the stabilisation and subsequent reduction in the banks' bond yields were (i) increased transparency in the banks' capital needs and related assurances of available recapitalization funds, (ii) announcements on the implementation of reforms, and (iii) the decision not to bail-in bank debt.

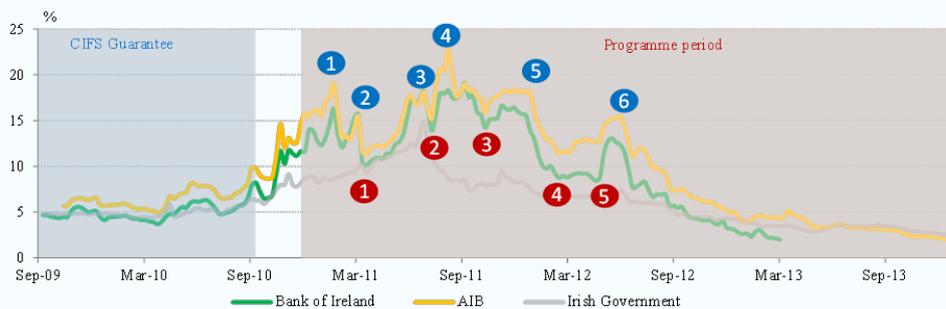
The absence of significant surprises in the support needed by the financial sector was an important element in the success of the programme, in particular in allowing the vicious loop between the sovereign and the banks to be broken. The total gross disbursement of public funds for the Irish banking sector amounted to slightly over €18.1 billion during the programme period. Almost all the public injection related to the bank recapitalisation that ended in July 2011. The exception was €1.3 billion that was temporarily injected to cover for the sale of Irish Life.

In hindsight, July 2011 appears to be a key turning point, following the termination of the recapitalisation process and the statements by EU leaders and the Troika partners committing to provide sufficient support to the countries under a programme.

Progress in the implementation of the programme measures underpinned further reductions in sovereign and bank yields in the following months. By the time ECB President Draghi assured markets that the ECB was "ready to do whatever it takes to preserve the euro", and subsequently announced the possibility of OMTs of sovereign bonds in secondary market in summer 2012, Irish bank and sovereign yields had already dropped significantly from the 2011 peak.

By the end of 2012, both AIB and BOI managed to return to the unguaranteed senior debt market and raise €500 million and €1 billion respectively. This was at a yield slightly above 3%, although on a secured basis. By the end of the programme, AIB and BOI managed to raise €2.5 billion (of which €500 million unsecured) and €3.5 billion (of which €500 million unsecured) of senior debt, respectively.

Graph 1: **Bond yields**



Source: Bloomberg

Notes: Bank of Ireland yield refer to the "yield to maturity" of the bond BKIR 4.625 04/13 (ISIN XS0456135184, Notional Eur 1000mio, Issue Date 29/09/09). AIB data refer to the "yield to maturity" of the bond AIB 5.625 11/14 (ISIN XS0465876349, Notional Eur 700mio, Issue Date 05/11/09). Irish Government data (grey background) refer to the "yield to maturity" of the bond IRISH 5.9 10/19 (ISIN IE00B6089D15).

(Continued on the next page)

Box (continued)

Selected News Extracts

News related to Credit Tightening

- 1 15 Feb 11 - Economic and Monetary Affairs Commissioner Olli Rehn said there is "no appetite" for imposing losses on senior bondholders at Irish banks.
- 2 31 Mar 11 - PCAR Stress tests are published. Irish Finance Minister M. Noonan said that the banking stress tests carried out are part of the efforts to restore investor confidence. He added that the government will be "back at the table" to discuss burden-sharing with senior bank bondholder in Anglo should the lender need more capital.
- 2 31 Mar 11 - ECB has decided to suspend the application of the minimum credit rating threshold in the collateral eligibility requirements [...] in the case of marketable debt instruments issued or guaranteed by the Irish government [...].
- 2 1 Apr 11 - The ECB in Frankfurt was "solidly opposed" to imposing losses on investors in senior bank debt, Finance Minister M. Noonan told. The ECB agreed to provide "ongoing" funding for the banks, he said.
- 3 15 July 11 - Ireland's central bank said EU regulators found BOI has sufficient capital to withstand a recession and losses on sovereign debt.
- 3 15 July 11 - AIB and its unit EBS won EU approval to receive an Irish government recapitalization of 13.1 billion euros.
- 3 15 July 11 - [...] the EU and IMF insisted in its quarterly report that the Irish government was "on track" and "well financed," and predicted its return to the debt market in the coming years.
- 3 21 July 2011 - "We are determined to continue to provide support to countries under programmes until they have regained market access, provided they successfully implement those programmes. We welcome Ireland and Portugal's resolve to strictly implement their programmes and reiterate our strong commitment to the success of these programmes." Council of the EU. Statement by the Head of State or Government of the EA and EU Institutions.
- 4 26 Aug 11 - Anglo said its first-half loss narrowed on declining loan losses after the lender sold assets to the country's so-called bad bank.
- 4 30 Aug 11 - Irish Finance Minister M. Noonan said that the country's banks have capital to write off some residential mortgages of financially-distressed customers
- 5 17 Jan 12 - Ireland's Prime Minister E. Kenny said new legislation on personal insolvencies is expected to come before government on Jan. 24 for approval.
- 5 18 Jan 12 - Irish Finance Minister M. Noonan said the country is committed to not imposing private-sector losses on its sovereign or senior bank debt.
- 6 18 Jun 12 - S&P says proposed personal insolvency legislation may accelerate widespread loan write-downs
- 6 19 Jun 12 - Irish Finance Minister M. Noonan said he's "reasonably confident" that the nation will return to international debt market as planned.

News related to Credit Widening

- 1 4 May 11 - Portugal's caretaker prime minister says he has reached agreement on a bail-out from the EU and the IMF.
- 1 5 May 11 - Anglo senior bondholders are in a "very different category" from those of the country's two main banks, Irish authorities said. "If a requirement comes in for further capitalization the government will treat that in a different way to the two pillar banks".
- 2 28 Jul 11 - Cypriot President ordered his cabinet to resign as political discord deepens after a munitions blast wrecked a main power plant and Moody's Investors Service cut the government's credit rating.
- 2 29 Jul 11 - Ireland's central bank cut its economic growth forecast for this year and next as falling consumer spending outweighs increases in exports
- 3 27 Oct 11 - Europe's banks will need to raise 106 billion euros in fresh capital under tougher rules being introduced in response to the EA's sovereign debt crisis, European Banking Authority (EBA) said.
- 3 27 Oct 11 - [...] euro-zone leaders agreed to reduce Greece's vast debt burden by half. In addition, the euro backstop fund will be boosted to over a trillion euros.
- 3 28 Oct 11 - Ireland's government broadened emergency bank laws as it prepares to inflict losses on the remaining junior bond holders.
- 4 2 Mar 12 - Irish Central Bank Governor P. Honohan said that small and medium-sized enterprises in Ireland face the toughest situation in obtaining credit in the EA.
- 4 2 Mar 12 - European leaders agreed to provide capital faster for the planned permanent bailout fund. At the same time, discussion on increasing the overall ceiling for rescue lending has been put off.
- 5 14 May 12 - Moody's placed ratings of 16 senior notes in six Irish residential mortgage-backed securities transactions on review for downgrade.

Source: Bloomberg News. Notes: First, the "turning" days were identified, as those days when the yield of the two banks' bond reversed their latest trend. Second, news marked as "important" by Bloomberg and published in the period starting two b-days before and terminating one b-day after the "turning" day were selected. Third, among them, news concerning facts or announcements from decision-makers related to Ireland or the euro crisis were selected and reported as closely as possible to the original text. This empirical analysis suffers some limits. Among the others, relatively small trading volumes of the analysed bonds, as recorded during the programme, tend to amplify prices and yield changes.

6. FISCAL POLICY MEASURES

This chapter looks at the reforms to fiscal policy and the fiscal framework. It presents the fiscal consolidation measures under the programme, followed by discussion of the reforms to the institutional context within which fiscal policy is set. While the sets of reforms associated with these elements were reasonably distinct over the programme period, both ultimately share the same medium-term aim, which is to ensure the lasting and improved sustainability of the Irish public finances. The assessment presented at the end of the section therefore considers them together.

6.1. THE FISCAL CHALLENGE

The Irish economic adjustment programme was put together in the context of a severely weakened and uncertain fiscal position. The Irish budget balance went from a surplus in 2007 to a deficit of 14% of GDP by 2009. The Irish authorities requested financial assistance in late 2010, on the prospect that their 2010 budget deficit would amount to 31.7% of GDP⁽¹⁴⁰⁾. This was the result of both a large underlying fiscal deficit (forecast to come in at 11.7% of GDP) and the cost of measures in support to the banking sector (some 20% of GDP). Large uncertainty underlying the future needs of the banking sector and the Exchequer's ability to shoulder the costs were at the heart of the strong deterioration of Ireland's financial market access conditions.

Since the onset of the crisis, the Irish authorities had attempted to deal with the growing fiscal hole. They had introduced an estimated €14.6 billion of consolidation measures between July 2008 and December 2009, corresponding to some 9% of GDP. Still a substantial deficit which was largely structural remained, requiring a strong correction of the underlying fiscal dynamics.⁽¹⁴¹⁾ The sharp increase in the general government gross debt – from 25.0% of GDP in 2007 to a forecast of 97.4% by the end of 2010⁽¹⁴²⁾ – had eroded Ireland's fiscal space and had made the need for fiscal consolidation imperative.

Imprudent pro-cyclical fiscal policies in the run up to the crisis were at the heart of the explosion in the underlying deficit. The Irish fiscal deficit in 2010 was the largest in the EU; excluding the cost of the measures in support of the banking sector, it was second only to Greece. Fiscal policy choices during Ireland's long boom years were highly pro-cyclical, including expenditure commitments and tax reductions that were funded out of cyclical and asset-based revenues which disappeared when the crisis hit. A significant factor in the strong performance of the tax system in the pre-crisis years was the booming real estate market. The share of revenues linked to the property market, rose from 8.4% of tax revenues in 2002 to 18% in 2006. By 2010, these had plummeted to just 2.6% as the housing market crashed.⁽¹⁴³⁾ The direct contribution of the housing market to growth was compounded by the increased consumption linked to house price increases. When the property bubble burst this created a vicious cycle of recession, banking weakness and revenue shortfalls. Both the Irish Exchequer and the banking system had become overly reliant on the continued strength of the housing market.

The Irish government affirmed its commitment to continued fiscal consolidation in its NRP covering 2011-14. The NRP was a complete action plan designed to deliver further fiscal consolidation in line with the EDP Ireland was subject to⁽¹⁴⁴⁾, reflecting the preferences of the Irish government in terms of measures and approach to fiscal policy. The NRP put forward a consolidation package worth €15

⁽¹⁴⁰⁾ According to the Irish government's National Recovery Plan published on 24 November 2010, three days after the request for assistance.

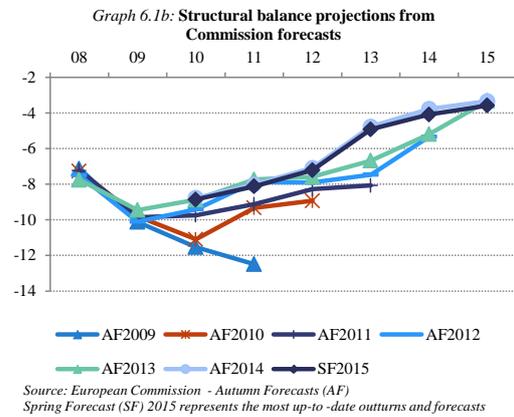
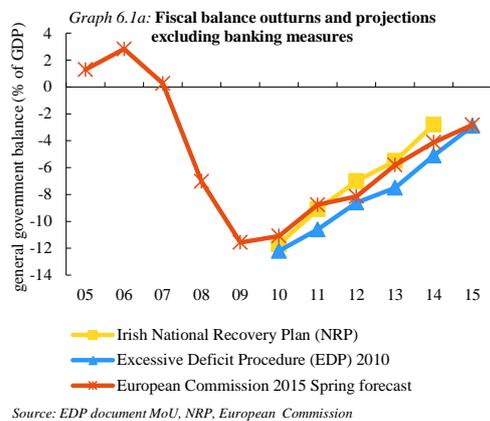
⁽¹⁴¹⁾ The Commission forecasts placed the output gap at about -5% of potential GDP in 2010 and the effect of the cycle was estimated to contribute 2.1% of GDP to the deficit. With an estimated structural deficit of 11.1% of GDP, it was clear that a large fiscal adjustment would be needed to return the budget balance to a healthy underlying position.

⁽¹⁴²⁾ According to the Commission 2010 autumn forecast.

⁽¹⁴³⁾ European Economy Occasional Paper 76/2010 Box 2, page 15.

⁽¹⁴⁴⁾ http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/30_edps/104-07_council/2009-12-02_ie_126-7_council_en.pdf

billion over 4 years, to meet the December 2009 EDP deadline for bringing the deficit below 3% of GDP by 2014. In line with the practice at the time, Ireland's EDP contained a deadline for correcting the excessive deficit and a quantification of the structural tightening that should deliver this, but no annual targets and no firm guidelines as to the composition of the correction were included. 2/3 of the consolidation measures laid out in the NRP were on the expenditure side and 1/3 on the revenue side, reflecting the choice of the Irish authorities to reduce expenditure as a share of GDP and allow revenues to stabilise. The €5 billion of envisaged revenue measures would fill the widening shortfall in tax receipts. Consolidation was to be frontloaded, with €6 billion being delivered in 2011 and the remainder being spread over the next 3 years. The NRP was based on a continuation of the key features credited with having generated prosperity for Ireland over the last 20 years, namely a relatively low tax burden based on low corporate taxation and financial incentives to attract foreign direct investment. As set out in the NRP document and confirmed in interviews with the Irish authorities, the retention of the 12.5% corporation tax rate was a red line for the Irish authorities.



The pro-activeness of the Irish authorities and their readiness to only make commitments for measures they were confident they could deliver enabled them to have a strong input into the fiscal policy agenda during the programme. The programme's fiscal conditionality called specifically for the implementation of the Irish government's four year consolidation plan.⁽¹⁴⁵⁾ Programme conditionality was kept broad, with the precise design of the actual measures left up to the Irish government in most cases. Interviews with the Irish authorities and staff of the three institutions confirm that that this was an explicit choice, to allow the implementation of the programme to remain effectively and visibly as much as possible under the responsibility and ownership of the Irish administration.

6.2. THE FISCAL REFORMS AND EVOLUTION OF THE PUBLIC FINANCES OVER THE PROGRAMME PERIOD

The aim of the fiscal conditionality under the programme was to ensure that Ireland took the necessary measures to close the hole in its public finances and restructured its budget to ensure public finance sustainability. The MoU contained overall targets in terms of the global figures and dynamics of the government budget, to ensure that the government was able to cover its financing needs subject to the agreed envelope and to comply with the requirements of the Stability and Growth Pact (SGP). The MoU also specified the direction and aims of the reforms to be introduced on both the revenue and the spending sides, so that pre-existing weaknesses in the underlying structure of the Irish budget would be addressed.

⁽¹⁴⁵⁾ The NRP covered 2011-14, while the MoU covered 2011-13. It therefore called for the implementation of the first three years of the plan for the programme years, with the final year coming after the end of the programme.

Table 6.1:

Overview of fiscal figures (% GDP unless otherwise stated)

December 2010 Memorandum of Understanding		2010	2011	2012	2013	2014	2015
Budget balance (net of banking support measures)		-32.0 (-12.2*)	-10.6	-8.6	-7.5	-5.1	-2.9
Revenues		35.2	34.9	35.0	34.9	34.8	35.0
Spending		67.2 (47.4*)	45.5	43.6	42.4	39.9	37.9
<i>of which:</i> current		41.8	40.8	39.3	38.5	36.4	34.6
gross fixed capital formation		4.5	3.5	3.1	2.8	2.4	2.3
interest		3.0	3.8	4.6	6.0	6.2	6.1
Gross debt		95.0	112.4	118.7	120.5	119.1	115.5
<i>Measures in €bn</i>							
New revenue measures			2.1**	0.9	0.9	0.9***	
revenue carry-over from previous budget				0.6	0.3	0.2***	
spending			3.9	2.1	2	2***	
other			6.0	3.6	3.1	3.1***	
Outturns		2010	2011	2012	2013	2014	2015
Budget balance		-32.5	-12.7	-8.1	-5.8	-4.1	-2.8
net of one-offs		-11.1	-8.8	-8.1	-6.2	-4.0	-3.1
net of banking one-offs		-11.1	-8.8	-8.1	-5.8	-4.1	-2.8
Structural balance		-8.9	-8.1	-7.2	-4.9	-4.1	-3.6
Revenues		33.6	33.5	34.2	34.9	34.9	34.4
Spending		66.1 (44.7*)	46.3 (42.3*)	42.3	40.7	39.0	37.2
<i>of which:</i> current		40.3	39.0	39.4	38.7	36.5	34.6
gross fixed capital formation		3.4	2.4	2.0	1.8	1.9	2.0
interest		3.0	3.4	4.1	4.4	4.0	3.6
Gross debt		87.4	111.2	121.7	123.2	109.7	107.1
<i>Measures in €bn (figure for full year impact)</i>							
New revenue measures			2.1**	0.9	1.1		
revenue carry-over from previous budget				0.7	0.3		
spending			3.9	2.2	1.5		
total			6.0	3.8	3.0		

* net of banking measures. The MoU did not give an outturn figure for 2010 net of banking measures. However, the EDP issued at the same time gives the banking support measures of 2010 as equalling 19.8% of GDP

of which €0.7bn of one-offs *from the NRP - 2014 was not part of the adjustment programme

Source: Memorandum of Understanding, EDP decision of December 2010, outturns from Commission 2015 Spring forecasts

The overall fiscal conditionality under the Irish programme was framed in terms of both the yield of the measures to be delivered and of nominal targets for the overall budget deficit. The measures to be delivered corresponded to the first three years of the €15 billion package set out in the NRP by the Irish authorities over the years 2011-14. According to the Troika, the implementation of the NRP measures was expected to lead to a general government deficit of 10.6% of GDP in 2011, 8.6% in 2012 and 7.5% in 2013, the last year of the programme, not counting any measures in support of the banking sector. From an EU perspective, the nominal path of the deficit was crucial as it is a key figure against which deficit-based EDPs are assessed and eventually abrogated. ⁽¹⁴⁶⁾

The programme targets were aligned with a newly extended deadline for the correction of the excessive deficit, which reflected the changes in macroeconomic conditions, underlining the EU's added-value. The EDP provides a flexible legal framework for ensuring that the fiscal consolidation path is adhered to. In December 2010, the existing EDP was extended to reflect the consolidation path agreed under the programme. While the Irish authorities forecast that implementing the NRP would bring the deficit below 3% of GDP by the 2014 deadline, the Commission services took a more cautious approach

⁽¹⁴⁶⁾ In 2009, all EDPs were opened on the basis of the nominal deficit.

in the light of high uncertainty, forecasting a general government deficit of 5.1% of GDP for 2014. Following discussions within the Troika, the choice was made to recommend the extension of the EDP by one year, making 2015 the deadline for the Irish deficit to come in below 3% of GDP, and retain the reform agenda set out in the NRP. As required by the legislation at the time, the EDP specified a cumulative adjustment of the structural budget over 2011-15 (9 ½p.p. of GDP) that was expected to lead to a correction of the excessive deficit by 2015, but no starting point nor annual path for the structural balance was specified. The MoU did not define the adjustment required in terms of the structural balance, either ⁽¹⁴⁷⁾.

The way in which the NRP measures determined the deficit targets, set the stage for the monitoring of the programme to be primarily focused on the delivery of the policy response, with the automatic stabilisers operating freely. In practice, the monitoring of the Irish fiscal conditionality was simplified by the fact that compliance with the reform effort led to compliance with the deficit targets. Had economic outcomes been less favourable, this need not have been the case. The more difficult choice of whether to stay the course and focus primarily on the policy effort despite an emergent fiscal hole relative to the overall deficit targets would then have had to be taken.

The extension of the deadline for correction of the excessive deficit to 2015 ensured that the intermediate targets were achievable and Ireland eventually over-performed on its annual fiscal deficits. Ireland would not have met the original 2014 deadline for the deficit to come in below 3% under the measures implemented. Had the EDP deadline remained at 2014, the programme years would have been marked by doubts as to compliance with the EDP, undermining the narrative of success, as the intermediate deficits for 2012 and 2013 set out in the NRP would also have been missed. However, the tighter constraint for 2014 would have meant that the Irish authorities would have had to continue with a more sustained pace of reforms in the first year after the programme.

The change in accounting basis from the 1995 European System of Accounts (ESA) to ESA 2010 makes comparisons difficult. The change in ESA increases nominal GDP, lowering the value of all indicators that are measured as a share of it, such as the government deficit. In parallel, the concept of the general government has been widened. ⁽¹⁴⁸⁾ As a result of the changes, it is more meaningful to compare the evolution of the deficit and its components rather than to focus on its level, as the impact of the reclassification changes is more limited. Over the programme years, the headline deficit tightened by 4.9p.p. of GDP, compared with a 4.7 p.p. targeted reduction in the MoU, excluding banking support measures ⁽¹⁴⁹⁾. The strong overachievement of the deficit relative to the annual targets is primarily driven by the revisions to the 2010 starting point, rather than to a stronger improvement year on year.

The Irish authorities implemented measures in line with the MoU plans. As shown in table 6.1 they implemented an estimated €6.0 billion of measures in 2011, €3.8 billion in 2012 and €3.0 billion in 2013 (corresponding to 3½%, 2¼% and 1¾% of GDP respectively). This points to a strong front-loading of the policy response under the programme. However, the Irish authorities had already passed €14.6 billion of consolidation measures over 2008 and 2009. The consolidation under the programme therefore represents an easing of the very intense reform effort relative to the €11.6 billion of measures passed in 2009 and which were effective from the second half of 2009 and 2010. The front-loading under the programme is in contrast to the profile obtained by looking at the change in the structural balance, which tightened by 4 p.p. of GDP over the programme period and showed a tightening of just 0.7p.p. in 2011, 0.9p.p. in 2012 and 2.3p.p. in 2013. Graphs 6.2 show the different estimates of the reform effort, comparing the change of the structural balance estimates and its components to the measurement of the reforms taken. The difference between the front-loading indicated by the bottom up measurement of the

⁽¹⁴⁷⁾ This issue is picked up in greater detail in a later section of the chapter.

⁽¹⁴⁸⁾ Chapter 4 of European Economy 9/2014 explains this in more detail. http://ec.europa.eu/economy_finance/publications/european_economy/2014/pdf/ee9_en.pdf

⁽¹⁴⁹⁾ Irish revenues increased by 1.5p.p. of GDP more between 2010 and 2013 than expected at the time of the programme (from 33.6% to 34.8%, rather than from 35.2% to 34.9%). Conversely, spending fell by around 3¾ rather than 5 p.p. of GDP.

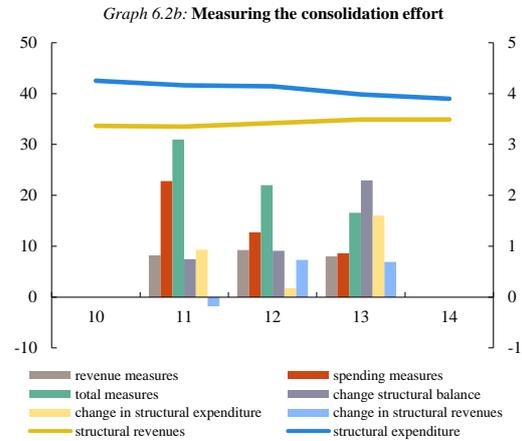
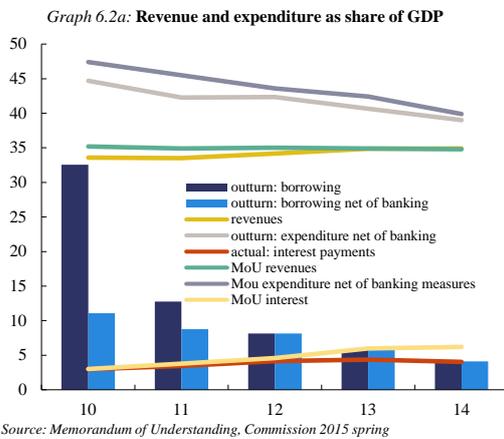
reforms and the back-loading shown by the change in the structural balance indicates that at least one of the two approaches is not a realistic reflection of the policy response of the Irish authorities. In practice, both have shortcomings, but the structural balance is at its weakest in situations of strong economic change, as was the case in Ireland over the crisis years.

Ireland is forecast to meet its 2015 EDP deadline despite delivering a much lower tightening of the structural balance than set out in the EDP. According to the Commission 2015 winter forecast, Ireland's deficit should come in below 3% in 2015, on the basis of a cumulative 5½% structural tightening, rather than the 9½% set out in the EDP. While the change in the starting point for the deficit has played a role in this, the primary reason is that large revisions in the potential output throughout the programme period make the structural balance a very unstable measure for countries at a time of strong economic adjustment. The structural balance attributes any change in expenditure that differs from potential growth or any change in revenues that is not explained by standard (although country-specific) semi-elasticities being applied to the output gap to policy measures. However, in times of change, the concept of potential output is very difficult to quantify and elasticities are likely to vary over time. The inherent difficulties in estimating the structural balance in real time are evident from the large revisions shown in graph 6.1b. In addition, in uncertain economic times, there is also no reason to expect expenditure and revenues to follow standard patterns of behaviour captured by semi-elasticities as economic fundamentals are shifting. This has led to reframing the way "effective action" is assessed under the EDP over the course of the crisis years, to take more account of how the structural balance is affected by potential growth estimates and to include bottom-up estimates of policy measures, which attempt to correct for the behaviour of elasticities. The bottom-up methodology yields a higher estimated policy response in the case of Ireland.

The link between output and fiscal performance is weaker in Ireland than in other countries due to the high profit and income outflows which make GNI much lower than GDP. Ireland is an outlier in this due to the high level of foreign investment in its economy. As GNI is arguably more closely tied to tax revenue ⁽¹⁵⁰⁾, using GDP as a guide of the underlying expected performance of fiscal policy may not fully reflect the adjustment. For example, the structural balance implicitly assumes that revenues should be more buoyant in 2011 when real GDP grew strongly, than would have been the case if revenues tracked GNI more closely. Conversely, in 2012 and 2013, GDP growth was low and any strong showing by revenues (attributable to GNI being strong) would therefore be classified as a fiscal tightening under the structural balance. This would result in a more backloaded profile of the policy response being shown by the structural balance, than might be merited by the actual actions taken. As an alternative, an indicator akin to the structural balance built on a concept of potential GNI rather than potential GDP could have been envisaged in overcoming this issue with structural balance. More generally though, the Irish programme was prescient in pre-empting the weaknesses of the structural balance at times of changing economic relationships, by side-lining it as a measure of the policy response. It should also be noted that the three institutions do not share a common methodology to calculate potential output – and thus the output gap and structural balances. Therefore, this metric was inappropriate for policy negotiations and setting of targets in the governance framework established for EA adjustment programmes.

Although there were strong merits in focussing on the nominal value of the measures to judge the consolidation effort, the monitoring of the fiscal adjustment had some weaknesses due to difficulties in measuring the impact of measures. Given that measurement difficulties are inherent to most attempts to quantify the budgetary impact of fiscal policy reforms, the programme could have benefited from a clearer explanation as to how the budgetary impact would be measured from the start of the programme. The ex-ante specification of the impact of measures to be introduced was set out by the Irish authorities in

⁽¹⁵⁰⁾ It should be noted that GNI is inflated by retained profits of re-domiciled companies with little economic presence in Ireland, which do not generate tax revenues for the Irish Exchequer. However, despite a growth in such companies in recent years their effect on the overall figures is more limited than the effect of MNC on GDP. An explanation on the impact of re-domiciled companies of national income is available at: https://www.esri.ie/UserFiles/publications/QEC2015SUM_SA_FitzGerald.pdf



the NRP. For the tax measures, this consisted in the estimated gross effect of measures, before any second round impact on other items. However, no ex post assessment of the actual impact of the measures was undertaken.⁽¹⁵¹⁾ For the spending measures it was defined as the difference in expenditure between the pre-existing government plans and those that would be delivered in order to meet the (original December 2009) EDP deadline of 2014. In the assessments undertaken under the programme, the impact of the expenditure measures was particularly difficult to decompose. This is not unique to the Irish case – determining how high spending would have been under a counterfactual of no reform is always subject to some judgement – but the programme would have benefitted from a more explicit definition of how expenditure savings were to be measured. For revenues, a more detailed examination of the impact of measures introduced would have added more transparency and understanding to the underlying dynamics to the Irish fiscal balances.

Realised annual GDP growth during the programme period makes it difficult to argue that the decision to undertake half of the programme fiscal adjustment in the first year was wrong in the Irish case. The Irish programme came after €14.6 billion of consolidation measures introduced since 2008, with most of the impact coming in late 2009 and 2010. With the immediate pressure of the market off, the economic adjustment programme could have allowed an easing of the consolidation effort in 2011, pushing more of the measures into 2012 and 2013, to help underpin growth which remained vulnerable. Small open economies typically display lower fiscal multipliers, and have less growth response to fiscal consolidations.⁽¹⁵²⁾ However, in times of economic crisis, when more individuals are credit constrained and monetary policy is less able to be accommodative, fiscal multipliers are higher, making a case for delaying consolidation efforts, other things being equal. The choice was made to continue with the adjustment process that was already well underway rather than extend the years of substantial effort. This was done in part to make full use of the political capital that had already gone into two years of adjustment before the programme and to accelerate the restoration of market confidence. There was also a concern not to add to the already high level of debt, by unduly delaying consolidation. At the time the programme was put together, 2011 was forecast to be the first year of positive growth at 0.9% before growth would pick up further in 2012 and 2013 to 1.9% and 2.5%, respectively (see table 6.2). In the event, 2011 turned out to be unusually strong both in Ireland and amongst its trading partners, with growth coming in at 2.8%, supported significantly by net exports. This should have allowed a better absorption of the contractionary impact of the consolidation than might otherwise have occurred. On this basis, it is difficult to argue that it would have been better to backload the consolidation.

⁽¹⁵¹⁾ Such ex post evaluations are difficult to implement – as a result few countries undertake such an exercise.

⁽¹⁵²⁾ See for example Jan in 't Veld, 'Fiscal consolidations and spillovers in the Euro area periphery and core', European Economy, Economic Papers, 506, October 2013.

Table 6.2:

Economic growth forecasts and outturns

Commission 2010 forecasts	2010	2011	2012	2013	2014	2015
Real GDP growth	-0.2	0.9	1.9	2.5	3.0	3.0
Domestic demand contribution	-4.4	-3.2	-0.6	0.3	1.0	1.0
Net trade contribution	3.4	3.7	2.5	2.2	1.9	2
Gross national income (GNI growth)	-2.7	-0.3	0.3			
Outturns	2010	2011	2012	2013	2014	2015
Real GDP growth	-0.3	2.8	-0.3	0.2	4.8	3.6
Domestic demand contribution	-4.3	-1.3	-0.1	-0.6	2.3	2.8
Net trade contribution	3.2	5.7	-0.8	0.6	2.2	0.8
Gross national income (GNI growth)	0.7	-0.5	0.3	3.2	6.1	3.8

Source: Commission 2010 Autumn forecasts, Outturns from Commission 2015 Spring forecasts

Even when looking beyond GDP, the degree of frontloading as evidenced by the impact of the measures introduced, was probably appropriate. Looking at GNI instead of GDP gives a different overall picture of the performance of the Irish economy. GNI came in at -0.5% in 2011, a higher retrenchment than the -0.3% forecast. It turned positive in 2012 before picking up strongly in 2013. In parallel, 2011 saw unemployment increase to 14.7% of the work force, against a forecast slight decrease. This puts into question the decision to consolidate more in 2011 than in 2012 or 2013. However, considering the confidence benefits of having taken the most difficult steps by 2011 and considering the strong GNI growth that followed, the consolidation profiling decisions taken in late 2010 have stood the test of time well. The consolidation under the programme fitted into the broad agenda that had already begun in 2008 which gave a certain inertia to the process. It should also be borne in mind that the Irish headline deficit was still high when exiting from the programme, leaving substantial consolidation efforts to be made in the post-programme period. As significantly better-than-expected GDP growth in 2014 has led to the re-emergence of pro-cyclical fiscal policy reflexes, locking in major consolidation achievements early under the programme has proven all the more justified.

The consistent compliance with the fiscal targets helped foster a virtuous circle of good news and credibility for the programme, underpinning the ability of the government to deliver on the programme. A number of factors were key in this respect. First, the deficit targets were realistic, allowing their achievement on the basis of the delivery of the policy reforms. Second, the front-loading of the fiscal adjustment proved a strong point as it allowed the brunt of the impact in terms of policies to be introduced when the importance of adjustment was well understood by the general population, continuing a consolidation process that was well underway. Third, the programme targets were not adjusted to reflect savings to debt interest and strong economic fundamentals. Overall, the strong Irish involvement in the preparation of the programme bore fruit in terms of the delivery of the reforms. In this sense, the fact that the programme was based on a primarily expenditure-based consolidation should be viewed as reflecting the priorities of the Irish government to continue with a growth model that had delivered much to Ireland, rather than reflective of a belief in the greater success of such consolidations.

The decision not to adjust the programme targets in the light of an easing of interest conditions was beneficial to the credibility of the government delivering on its programme but whether or not it was the right one remains an open question. Over the course of the programme, the Irish interest bill fell for two reasons. First, starting in spring 2011, the costs of Ireland's market funding eased considerably. This improvement compared to the programme's initial fiscal projections offered the authorities some room for manoeuvre and allowed the automatic stabilisers to work in 2012 and 2013 in the context of worse than projected GDP growth. Second and on top of improving market sentiment,

Ireland benefitted from a reduction in the margins payable on the interest on the EFSM/EFSF loans as part of a larger EA political agreement struck in July 2011. ⁽¹⁵³⁾ Loan margins were adjusted to carry a total cost close to these facilities' funding costs, delivering some €4.9 billion of savings to the Irish sovereign for the period 2011–2020. This policy decision was a sizeable windfall gain for the Irish Exchequer and meant an easing of the compliance with the deficit targets. With hindsight it might have made sense to adjust the deficit targets in the light of the deliberate policy decision to reduce interest rates on official EU loans. This would have required maintaining, at least partly, the originally intended fiscal effort of the Irish authorities within the programme years, in response to an effective reduction of some of their liabilities. Not doing so allowed the Irish government a larger room for manoeuvre in delivering on its fiscal targets. The decision was made not to adjust the deficit targets in order to ensure fair treatment with the Greek adjustment programme and continued programme ownership. However, given that the reduction in the funding costs was an external policy change which unilaterally made financing conditions easier, rather than an exogenous market effect, it may have been appropriate to accompany it by deficit target revision. An alternative response might have been to reduce the financing envelope provided by the EFSM/EFSF (leading to a lower cash buffer at the end of the programme), reflecting the lower financing needs over the medium term.

The Irish fiscal adjustment programme avoided some of the difficulties in balancing the reform effort and fiscal targets, as both the volume of the measures and the nominal deficit targets were complied with. The focus on nominal targets allows conditionality to be less binding in the case of positive developments, whether they result from decisions linked to the programme such as the interest rate changes or are due to exogenous economic developments. However, their pro-cyclicality is a problem in the case of negative developments. Focussing on the reform effort allows negative surprises to be absorbed within the programme, but can undermine the reform effort if the deficit target is easily met. In the Irish case, over-compliance of the nominal deficit target did not lead to a watering down of the reform effort however.

Table 6.3:

Overview of fiscal figures (% GDP unless otherwise stated)

€ mln	forecasts			outturns				extra revenues		
	2011	2012	2013	2010	2011	2012	2013	2011	2012	2013
Current tax revenues	34,900	35,825	37,950	31,753	34,027	36,646	37,806	-873	821	-144
Non-tax revenues	1,970	2,495	2,360	2,687	2,774	2,819	2,676	804	324	316
All current revenues	36,870	38,320	40,310	34,440	36,801	39,466	40,482	-69	1,146	172

Source: Irish budgets, Department of Finance, Ireland

Over the years of the programme, revenues shifted towards direct taxes due to both policy choices and the composition of growth. The revenue measures introduced were skewed 2/3 towards direct taxes and 1/3 towards indirect taxes. Furthermore, the second order effect of the primarily expenditure based consolidation measures weighed more heavily on indirect taxes, contributing further to the reduction in their yield. The aim was to broaden the tax base to ground government revenues more closely to economic performance. The measures introduced in 2011 were strongly focussed on income tax and changes to the Pay-Related Social Insurance (PRSI), including the introduction of the Universal Social Charge – which is effectively a component of income tax – replacing the health and income levy. The increases in direct taxes continued in 2012 and 2013, but on a par with changes to indirect taxes. In 2012, VAT was increased from 21% to 23%, excise duties rose and capital taxes were increased. The increase in income taxes was primarily a second year impact from the measures of 2011. The biggest sources of revenue increases in the 2013 budget were excise duties, PRSI and the introduction of an annual recurring value-based local property tax. The Irish public finances also benefitted from a positive performance of non-tax revenues. As table 6.3 shows, government revenues came in stronger than expected over the

⁽¹⁵³⁾After debt sustainability and the financing situation in Greece deteriorated, official lenders decided to remove margins and forgo profits. To maintain the principle of equal treatment, the same policy was applied to Ireland and Portugal. (http://europa.eu/rapid/press-release_MEMO-11-602_en.htm?locale=en)

programme period. In 2011, there was a tax revenue shortfall of some €1 billion relative to the budget forecast (stemming primarily from weak excise duties, VAT, income tax and corporation tax revenues, which were partially offset by a stronger than expected yield of stamp duties), while in 2012 tax revenues came in stronger than expected (primarily from a stronger performance of corporation tax and VAT). Consistently, however the Irish Exchequer benefited from a strong performance of non-tax revenues over the years of the programme. ⁽¹⁵⁴⁾

The sequencing of the introduction of revenue measures was broadly appropriate as taxes with a potentially more negative impact on growth were introduced later. The increases in consumption taxes were delayed relative to the increases in taxes on income. Consumption remained weak through the whole period of the economic adjustment programme, but it was in 2011 and 2012 that its negative impact weighed more heavily on growth. Given that individuals were likely to be credit constrained, putting the increases in consumption taxes off until later during the programme period was appropriate. Conversely, the increase in income taxes was primarily timed when the large degree of slack in the economy could be expected to reduce the supply side impact.

The reforms to the tax system broadened the tax base and should reduce volatility, although another consumption led boom would pose a risk in terms of pro-cyclical fiscal policy. The NRP was prepared following a taxation review that took place over 2008 and 2009⁽¹⁵⁵⁾, and which recommended that direct taxes be increased through a broadening of the tax base and a reduction in allowances which had taken 45% of wage-earners out of the tax system. The changes to the income tax schedule, the Universal Social Charge and changes to the PRSI increased the tax base both at the bottom and the top of the income distribution, with taxes and social contributions being paid at lower levels of income than in 2010 and at higher rates further up the income distribution. Taken together, the changes have created an income tax system which is broader based with a greater percentage of the population contributing to revenues, rooting the public finances more strongly in the underlying fundamentals of the Irish economy. The income and social insurance system were also simplified, taking away exemptions that rendered the system complex. However, the different schedules for income tax, Universal Social Charge and the PRSI still leave a system that is far from straightforward in its application. The introduction of the Local Property Tax moved property taxation to a more stable value-based annual tax – and hence more permanent sources of income – rather than being reliant on stamp duties which are more immediately tied to the state of the housing market. ⁽¹⁵⁶⁾

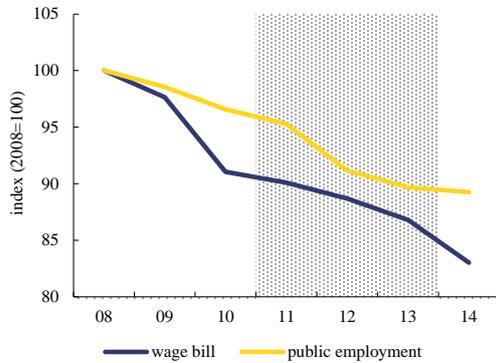
On the expenditure side, cuts were spread between current and capital expenditure. During the boom years, social expenditure and public sector wages increased and combined constituted over two-thirds of gross expenditure in 2010. Against this background, the authorities focused the current expenditure reductions on these two items. Social Protection expenditure as a percentage of GDP fell from 14.7% of GDP to 13.7%. The compensation of public employees was reduced from 11.7% of GDP in 2010 to 10.7% in 2013. It remains the second largest item of government expenditure in Ireland, corresponding to around a quarter of overall expenditure. In addition, just under 1p.p. of GDP in consolidation measures came from a reduction in intermediate consumption, which fell at a similarly proportionate rate. Finally, a reduction in gross fixed capital formation provided most of the remaining fall in overall spending, with capital spending halving as a share of GDP from 3.4% of GDP in 2010 to 1.8% by the end of the programme period. This sharp decrease could potentially have negative repercussions for future growth. During interviews some stakeholders expressed their concern that while

⁽¹⁵⁴⁾ These revenues are primarily one-off and are due to fees from the Bank Guarantee Schemes, higher Central Bank profits and dividend payments on the contingent capital provided to the Irish banking system.

⁽¹⁵⁵⁾ The Commission on Taxation was set up in early 2008 with a view to presenting a report detailing how best to reform the tax system to deliver the government's programme. It was given just under 18 months to examine the operation of the Irish tax system in detail for the first time in twenty-five years and its report was published in September 2009. <http://www.commissionontaxation.ie/Report.asp>

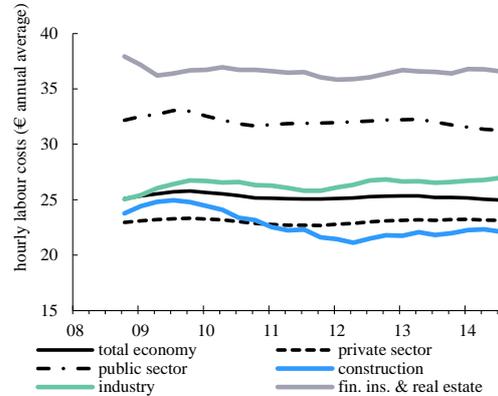
⁽¹⁵⁶⁾ Although these factors will result in revenues being more closely linked to economic fundamentals, the stamp duty schedule can still be expected to yield sizeable windfalls to the Exchequer, thus not entirely alleviating concerns that pro-cyclical fiscal policies of the past will not return.

Graph 6.3a: Public sector employment and wage bill



Source: Central Statistics Office, Ireland (CSO)

Graph 6.3b: Wage differentials across econ. sectors



Source: Central Statistics Office, Ireland (CSO)

there was a good case to reduce capital spending, the resulting level barely ensured the maintenance of past investments, in particular regarding infrastructure. In the years prior to the crisis, Ireland had invested strongly in infrastructure and upgraded the scope and quality of its transport networks.

The reduction in the public wage bill came about from reductions in both the number of employees and net wages – particularly at the higher end. Substantial savings to the public sector pay and pension bills had been enacted as part of the Irish government's consolidation measures prior to the assistance programme. Following a freezing of pay in 2009, from March 2009, public servants' pay became subject to a Pension Related Deduction on a sliding scale from 3% to a marginal rate of 10% for pay over €20,000. A pay reduction effective from 1 January 2010 was passed 9 months later reducing pay by between 5% and 15%. Taken together, the two measures reduced pay by around 14% on average. At the same time, public sector employment was reduced gradually. In response to the unilateral pay reductions imposed on public servants in 2009 and 2010, a period of industrial action ensued by public servants. In June 2010, the government and the employee representatives of public servants signed the Croke Park Agreement covering the period 2010-2014, stipulating that the hiring freeze and the moratorium on promotions were to continue, but that no further pay reductions be made to public servants already in service, unless additional unforeseen budgetary risks arose. This agreement was honoured under the adjustment programme and replaced in May 2013 by the Haddington Road Agreement, to enable the government to meet post-programme fiscal targets. This new agreement introduced a pay reduction for those public servants earning more than €65,000 annually and a reduction of several allowances⁽¹⁵⁷⁾. As a result, the reduction of the public sector wage bill accelerated again in 2013. Overall, the reduction in the public sector wage bill over the programme period was broadly on target with an achieved €0.9 billion savings compared to around €1.1 billion estimated at programme inception.

The aim of avoiding disruptions to the functioning of the public administration might have prevented more ambitious measures regarding the public wage bill. Public sector wages in Ireland are considerably higher than private sector wages. To a large extent, this reflects the fact that public sector workers are, on average, more highly skilled than private sector workers. Figure 6.3b presents raw gross earnings levels – and so does not take account of the Pension Related Deduction. It shows a slightly greater fall for hourly labour costs in the public relative to the private sector, although primarily before rather than during the programme years. Given the sharp cuts that were introduced to the welfare bill, there was some scope to have shifted more of these cuts onto the public sector by introducing further cuts to public sector wages in the programme years. Relative to the magnitude of the fiscal challenge and conditioned on the Irish government's choice to effect most of the consolidation through expenditure cuts,

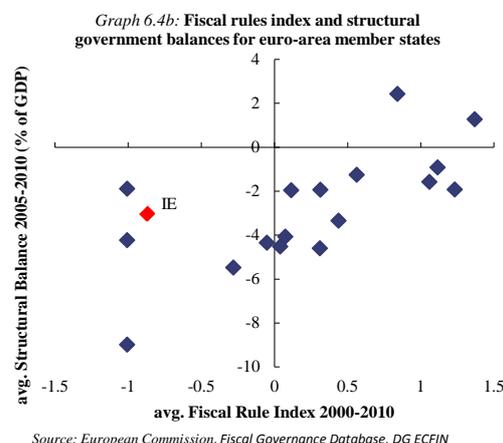
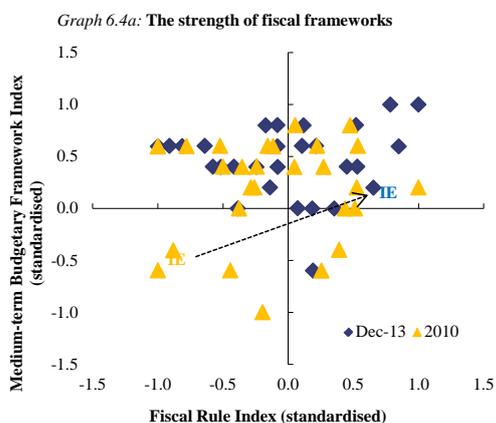
⁽¹⁵⁷⁾ Reductions varied between 5.5% (for those earning more than €65,000 annually but below €80,000) and 10% (above €185,000 annually) in function of income brackets. For more details, also see "Public Service Stability Agreement 2013-2016 – the Haddington Road Agreement" of May 2013.

the Croke Park and Haddington Road agreements were instrumental in protecting insiders' conditions. At the same time both agreements had the benefit of keeping relative social peace with no major strikes disrupting the functioning of public administration during the programme period and came on the back of substantial cuts prior to the programme.

Spending on social protection was reduced, despite increased unemployment. The restructuring of the social support system, through the introduction of pathways to work which represented a shift towards active labour market policies, took place at a time of increased demand for income-related support. With unemployment continuing to fall, the effect of the reforms should lead to further reductions in social benefits over the coming years. Proportionately, cuts to social welfare benefits were also bigger compared to the public sector wage bill. While this should increase work incentives over the medium term – particularly when accompanied by active labour market policies – it would not have had any effect in reducing unemployment at a time when unemployment would have been a demand rather than a supply problem. In addition, the welfare claimants are likely to be more credit constrained, leading to a more negative impact on demand from cutting welfare transfers.

6.3. THE INSTITUTIONAL CONTEXT TO FISCAL POLICY-MAKING

Prior to the programme, the Irish fiscal governance framework ranked among the weakest within the EU. ⁽¹⁵⁸⁾ This weakness contributed to pro-cyclical fiscal policies during the boom years as the fiscal framework was unable to restrain the excessive growth in current expenditure. Countries where independent bodies were involved in the preparation and monitoring of budgets and which operated according to transparent guidelines have been shown to be better placed to deliver strong policy outcomes. ⁽¹⁵⁹⁾ Attention has increasingly turned towards the role of institutional fiscal frameworks and processes in shaping Member State's public finance outcomes.



The programme conditionality with respect to fiscal governance was intentionally left broad to accommodate the changing requirements from EU rules. The programme conditionality contained a number of key reforms to enhance fiscal credibility and anchor long-term debt sustainability: the putting in place of a reformed Budget Formation Process, the adoption of a fiscal responsibility law including a medium-term expenditure framework with binding multi-annual expenditure ceilings and the setting-up of a budgetary advisory council to provide an independent assessment of the government's budgetary position and forecasts. However, as the Irish programme was agreed at a time of legislative reform on fiscal governance at EU level, the main drive was to ensure strong compliance with the evolving

⁽¹⁵⁸⁾ See Graph 6.4 a, based on data compiled by DG ECFIN

⁽¹⁵⁹⁾ "Public Finances in EMU", *European Economy*, 4/2010, pp 98ff

legislative framework. At the time when the Irish programme was put together, the so-called Six Pack of legislation was being negotiated at EU level. This contained the Directive on national budgetary frameworks⁽¹⁶⁰⁾, which set minimum criteria that countries should comply with concerning accounting and statistics, the preparation of forecasts, numerical fiscal rules, the need to rely on medium-term budgetary frameworks, coordination arrangements and transparency. It was the first time that the EU legislated on the manner in which Member States choose to undertake their budgetary policy. The Directive was adopted in November 2011 with a roadmap for transposition into national law by December 2013. It therefore served as basis for the implementation of programme conditionality. However, in May 2013 the directive was supplemented by the Two Pack⁽¹⁶¹⁾ which gave a role to independent bodies in the preparation of EA countries' budgets and in the monitoring of their fiscal rules.⁽¹⁶²⁾

6.4. THE REFORMS TO THE FISCAL FRAMEWORK UNDER THE PROGRAMME

The fiscal rules and medium-term budgetary framework, adopted under the Fiscal Responsibility Act in 2012 and its amendment in 2013, place Ireland's fiscal governance framework among the strongest in the EA.⁽¹⁶³⁾ Since 2010, Ireland has achieved a significant improvement in its fiscal governance framework as results from the 2013 update of the fiscal governance dataset maintained by DG ECFIN show. Ireland introduced a structural budget balance rule and a debt rule. The former is defined in terms of compliance with the SGP's preventive arm Medium-Term Objective, a country-specific budgetary target set in structural terms, and the adjustment path towards it. These rules ensure that compliance with the preventive arm of the SGP and with the debt requirement on the corrective arm are automatically part of the Irish budgetary procedure. The Independent Fiscal Advisory Council (IFAC) was given the role of monitoring compliance with the fiscal rule and endorsing the economic forecasts underlying the budget, subject to independent opinion, in line with the requirements of the Two Pack.

The actual implementation of fiscal governance related measures was delayed, due to both the changing rules at EU level and the need to adjust some of the policy suggestions from the Irish side. The national budgetary framework Directive recognises that the appropriate governance procedures depend on the institutional situation of each country. For this reason, the reforms required need to be country-specific. During the programme, the initial policy suggestions by the Irish authorities were not always appropriate in addressing the requirements of EU legislation, with the simultaneous evolution of EU requirements complicating matters. As a result of these difficulties, the MoU deadlines were adjusted leading to a rather late introduction and adoption of fiscal governance measures, relative to the initial timetable. The late introduction is reflected in continued weak assessments until recently.

IFAC became operational on an interim basis in 2011 and was made permanent in 2012. This lag allowed the IFAC's operation to bed in before being codified on a permanent basis. A Comprehensive Expenditure Review (CER) was also published in late 2011, covering the years 2012-14. Ideally, this would have been set earlier so as to have played a role in the design of the consolidation path. Nevertheless the CER introduced ministerial expenditure ceilings set on an administrative basis, and important step. The multi-annual expenditure framework was strengthened in "Ministers and Secretaries (Amendment) Act 2013", adopted in July 2013, correcting a number of perceived weaknesses in its

⁽¹⁶⁰⁾ Council Directive 2011/85/EU on requirements for budgetary frameworks of the Member States (OJ L306, 23/11/2011)

⁽¹⁶¹⁾ Regulation (EU) No 473/2013 of the European Parliament and of the Council of 21 May 2013 on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the Member States in the EA <http://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=OJ:L:2013:140:FULL&from=EN>

⁽¹⁶²⁾ In the meantime, the intergovernmental Treaty for Stability, Convergence and Governance was signed by all EU countries except the United Kingdom and the Czech Republic in March 2012. This required that compliance with the preventive arm of the SGP be reflected in national fiscal rules, with independent institutions monitoring the rules. Although this was not an EU Treaty, the subsequent Two Pack included the provision on independent institutions, placing it within the EU legal context.

⁽¹⁶³⁾ See Graph 6.4a, based on data compiled by DG ECFIN.

http://ec.europa.eu/economy_finance/db_indicators/fiscal_governance/index_en.htm

structure. The 2013 amendment extended the multi-annual expenditure ceilings, which previously covered only the "voted" expenditure of central government leaving non-departmental central government as well as spending of the remaining entities of the general government outside the control total and put the ceilings on a statutory footing, albeit not one that was deemed by the Commission as legally strong enough to substantially reduce the leeway for discretionary changes to the ceiling. So the Irish fiscal framework was markedly strengthened over the programme years, but room for improvement remained at the end of the programme. ⁽¹⁶⁴⁾

The programme context helped ensure the proper transposition of the national budgetary framework Directive. The programme did not intend to go beyond what was supposed to be introduced in all EU Member States by the transposition of the Directive. However, the EU's value added in designing programme conditionality and of regular reviews is evident as it offered the opportunity to ensure that the transposition of the Directive in Ireland was as close as possible to the Commission's intentions. The programme created a permanent channel of communication which facilitated the provision of guidance as early as possible in the design process of the new fiscal framework.

In conclusion, fiscal governance measures introduced during the adjustment programme were appropriate and necessary in terms of improving institutional efficiency and ensuring compliance with EU legislation. The fact that measures introduced respected new EU legislation from the start has strengthened Ireland's fiscal framework considerably. Nevertheless, key elements of legislation regarding the multiannual expenditure framework were left until very late under the adjustment programme and concerns are still voiced in post-programme surveillance (PPS) reviews. ⁽¹⁶⁵⁾

6.5. ASSESSMENT

The programme was instrumental in strengthening the public finances, substantially reducing the government deficit over the years. The public deficit narrowed from 11.1% of GDP in 2010 to 5.8% in 2013, excluding the costs of support for the financial sector. The deficit reduction continued in 2014 reaching 4.1%, keeping Ireland on-track to meet its 2015 deadline for complying with the 3% deficit threshold under the SGP, albeit with the help of one-off measures. This should be achieved despite a much lower tightening of the structural balance than that set out in the EDP accompanying the programme (see section 6.1.2.). This is partly a reflection of the difficulties in using structural balance as the metric of reference for countries undergoing large economic changes.

The fiscal adjustment slowed the rate of increase of the debt to GDP ratio, with 2014 marking the turning point when debt fell for the first time since the onset of the crisis. After reaching a peak of 123.2% of GDP in 2013, debt fell to 109.7% in 2014. As shown in table 6.1, this level is lower than the 119.1% of GDP forecast at the inception of the programme, but is not directly comparable due to classification changes affecting both the definition of the general government and the composition of nominal GDP. The expected reduction in debt in 2014 is primarily driven by below-the-line operations equal to 10.6% of GDP, of which over half relates to the liquidation of IBRC, although underlying debt dynamics also led to a reduction for the first time since 2007. In 2014 Ireland achieved a nominal growth rate of 6.1%, in excess of the implicit interest rate of 3.5% on its debt, causing the denominator to increase faster than the numerator leading to reduction in the debt ratio by 3.0 percentage points of GDP. This natural debt reduction is forecast to continue in 2015 and 2016. Moreover, Ireland's primary surplus

⁽¹⁶⁴⁾ European Commission, 'Economic Adjustment Programme for Ireland – Autumn 2013 Review', 2013

⁽¹⁶⁵⁾ "Post-programme Surveillance for Ireland – Spring 2014 Report", ECFIN Occasional Papers Nr. 195, June 2014, p23
"Post-programme Surveillance for Ireland – Autumn 2014 Report", ECFIN Occasional Papers Nr. 210, January 2015, p27

is forecast to increase from -0.1% of GDP in 2014, to 0.7% of GDP and 0.6% in 2015 and 2016, respectively. ⁽¹⁶⁶⁾

At the onset of the programme, there were some doubts about the sustainability of the Irish debt. In 2010, debt had already increased from 24% of GDP in 2007 to 97% in 2010 ⁽¹⁶⁷⁾ and was forecast to rise to 121% of GDP by 2013. A large underlying deficit, coupled with the large uncertainty about the size of the needs of the financial sector raised the question of the medium-term sustainability of the Irish debt. This was particularly relevant to the IMF, where exceptional access assistance was granted to Ireland despite the risk that the public debt was not judged to be sustainable in the medium-term with high probability. ⁽¹⁶⁸⁾ This is normally a necessary criterion for financing to be provided, unless there is a high risk of international systemic spillover, which was deemed to be the case for Ireland.

The risks associated with the sustainability of the Irish debt abated over the course of the programme. The Irish programme was put together at a time of heightened and increasing market stress, which was reversed over the first two years of the programme. The gradual reduction in risk premia in the EA, the strong adjustment effort by the Irish authorities and the reduction in the margins payable on the EFSM and EFSF assistance along with the extension in maturities, sustainably eased the debt burden on the Irish Exchequer both over the short and medium-terms. As table 6.1 shows, by 2014 the interest burden on Ireland was 2/3 the level that was forecast in the MoU, signifying an annual saving of around 2% of GDP. The improved outlook for the Irish Exchequer was underpinned by Ireland's strong return to the markets half through its programme, which enabled it to end to the programme with a sizeable cash buffer. Since the end of the programme, Ireland has been able to borrow on the financial markets at falling interest rates which by late 2014 were below 2% for 10 year papers. In December 2014 Ireland made its first early repayments on its IMF loan, having obtained permission from the EFSF/EFSM to waive the proportionate early repayment clause. ⁽¹⁶⁹⁾ This allowed an early repayment of €9 billion of its loan (corresponding to 40% of IMF loan facility).

While the overall effect of the programme was to improve public finance sustainability, the decision to finance part of the programme through the NPRF raises questions. The NPRF was set up in 2001 with the aim of pre-funding Ireland's rising pension costs, due to population ageing. The fund was an explicit choice to use good economic times to fund future liabilities. In this abstract sense, it made sense to use it as a "rainy day fund" and allocate a section of the accumulated assets for counter-cyclical stabilisation under the crisis. However, given that the NPRF aimed to address a longer term issue that goes beyond ⁽¹⁷⁰⁾ the short or medium-term impact of the crisis, the use of its assets will have negative impact on longer-term sustainability unless some other means of funding the future costs of ageing is introduced or any losses made are recovered. As the NPRF, alongside the Irish Exchequer, invested in BOI and AIB – both of which remained viable – there is a reasonable prospect that they might be able to recover a sizeable part of any current accounting losses on this investment.

While improvements under the programme placed Ireland's fiscal governance framework among the strongest in the EA, the framework's institutional strength still needs to prove its worth in practice. Currently it is still too early to judge if the strengthening of the fiscal framework has permanently improved fiscal governance in Ireland. With growth returning and the budget balance exceeding expectations, the temptation is there to run expansionary fiscal policies, potentially repeating

⁽¹⁶⁶⁾ Commission 2015 spring forecasts, available here :

http://ec.europa.eu/economy_finance/eu/forecasts/2015_spring_forecast_en.htm.

⁽¹⁶⁷⁾ According to the 2010 Commission autumn forecasts: these figures have since been revised.

⁽¹⁶⁸⁾ <https://www.imf.org/external/pubs/ft/scr/2015/cr1520.pdf> page 13

⁽¹⁶⁹⁾ This clause contained in EFSM and EFSF agreements places those loans on an equal footing with the IMF loans in terms of early repayment. In the absence of the clause being waived, an early repayment of the IMF loans would mean that a similar proportion of the EFSF and EFSM loans would become due immediately.

⁽¹⁷⁰⁾ In 2014 the NPRF was replaced by the newly created Ireland Strategic Investment Fund (ISIF), which is an investment vehicle. It therefore has moved away from being a wealth fund funding future pensions, to a means for providing investment into the Irish economy.

mistakes of the past. The 2015 budget preparations raise questions about whether the fiscal council will be able to influence outcomes and steer the fiscal policy away from procyclicality in future years. Some of the uncertainty is not specific to Ireland; fiscal governance reforms are to a large extent untested across the EU. The move to introduce stronger fiscal frameworks is rooted in the evidence that countries with strong fiscal governance perform better in the quality of their public finances. It is a natural evolution from the introduction of fiscal rules – a policy reform that gained traction in the late 1990s and has led to an expansion of fiscal rules across the world. However, neither of these innovations have been sufficiently subject to the test of time yet either in Ireland, or in the EU overall. The need to adjust fiscal rules as the dynamics of their specification become clear is evident from the changes to the SGP at EU level. The ability of fiscal councils to be effective in shaping fiscal policy will depend on how well their specification and operation fit the challenges ahead, and on their ability to gain strong reputation for independence.

Over the medium-term, the real test of the quality of the adjustment and the ability to bring the debt down from its current level will come when good times return. Overall, the changes to the tax and spending system should improve the sustainability of the Irish public finances over the medium-term and add to the stability of the system. However, over the medium-term some of the issues that led to the policy mistakes before the crisis could return. Keeping an eye on the evolution of public finances over the coming years will therefore be vital to ensure that the underlying dynamics lead to a gradual but strong reduction of the debt and that gains made under the programme are not sacrificed as the urgency of ensuring sustainability recedes with a return of strong growth. On the revenue side, while the income tax and property tax changes provide the Irish Exchequer with a more permanent source of revenue, any return of a housing boom will still lead to an increase in temporary revenues linked to unsustainable asset-led consumption. Particularly in the light of the increased debt, it will be a key test for the strength of the new fiscal governance framework to ensure that this does not translate into increased spending instead of debt repayment. Pressures for spending may arise from concerns about the quality of public services in the face of the employment cuts or from calls for higher capital spending to support growth. If these demands were to materialise, the challenge will be to ensure that any increases in spending are financed out of permanent revenue measures rather than windfalls.

7. STRUCTURAL REFORM MEASURES

7.1. TARGETED REFORMS TO TACKLE UNEMPLOYMENT AND INEFFICIENCIES

The underlying competitiveness of the Irish economy meant that structural reforms were not critical to the immediate crisis response. Ireland is a high productivity economy with strong fundamentals, including flexibility and a skilled workforce. In some respects, such as mark ups in the final goods sector⁽¹⁷¹⁾ and the ease of doing business⁽¹⁷²⁾, Ireland was already among the best performers in the EU. However, in other respects – for example, a comparatively high price level and shortcomings in its competition policy – Ireland had performed less well in the pre-crisis period.

Hence, the structural reforms in the programme were appropriately limited. While the MoU stated that structural reforms were one of the key planks of the Irish programme, in practice they were lower profile than the financial and fiscal parts, particularly for the ECB and the IMF⁽¹⁷³⁾. A focus on structural issues also did not fit the Irish domestic narrative of the crisis being primarily banking-driven. The smaller scope of structural reforms in Ireland than other programmes was due to Ireland's stronger starting position⁽¹⁷⁴⁾. First, labour market reforms sought to address the direct fallout from the boom-bust cycle. The onset of the crisis saw unemployment rise from 4.5% in 2007 to 13.5% in 2010 (Graph 7.1b). In this context it was right for the programme to include measures to tackle both demand side (wage setting) and supply side (activation, skills and work incentives) issues to support sectoral reallocation and combat the risk of hysteresis. Second, there were product market and sectoral reforms to address more long-standing economic inefficiencies which held back growth, directly or via the burdens they imposed on the Exchequer and businesses. Effective implementation of these reforms can help to complete the post-crisis economic adjustment, support future growth employment and productivity, and lower prices in protected sectors.

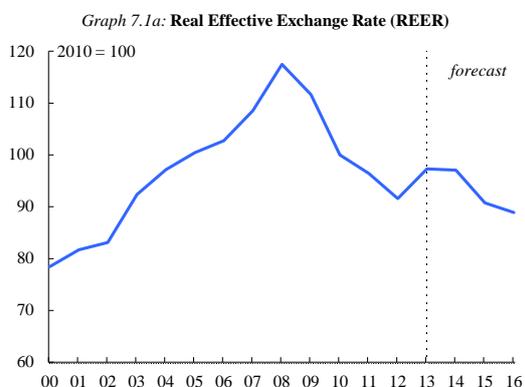
The original programme MoU built on existing plans; skills and health measures were added with a lag. The structural measures in the original programme MoU were largely in line with the Irish authorities' NRP, which was itself finalised when discussions with the three institutions on economic adjustment were already underway. The measures in the MoU were appropriate, but parts of the MoU lacked specifics or called for further analysis. Where necessary, measures were refined in later reviews. This was broadly understandable given the need to put the programme together quickly. It did, though, imply a heavy reliance on the commitment and the ability of the Irish authorities to develop and implement reforms. In the course of the programme, further measures were added to the programme MoU. These included Further Education and Training (FET) (mentioned in the 4th Review, prominent from the 9th Review), pharmaceutical expenditure (widened in scope from the 8th Review), and the cost-effectiveness of the health system (from the 10th Review). As discussed later in this section, these additions were warranted and improved the programme, but could arguably have been identified and included at an earlier stage. Stakeholder consultation and analysis of available information have not indicated any other major structural reforms that clearly should have been in the programme.

⁽¹⁷¹⁾ Commission Services, 1996-2007.

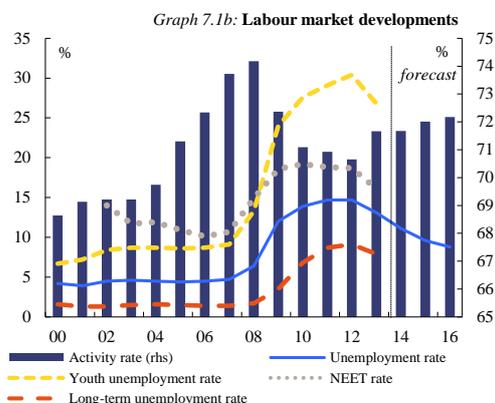
⁽¹⁷²⁾ World Bank Doing Business Database.

⁽¹⁷³⁾ IMF (2015) Ireland: Ex Post Evaluation of Exceptional Access Under the 2010 Extended Arrangement, Country Report No. 15/20.

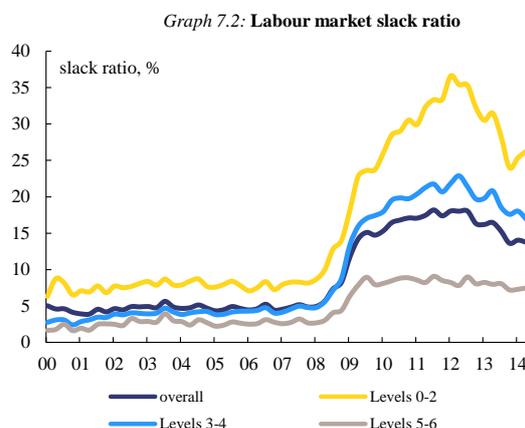
⁽¹⁷⁴⁾ Ireland's position on the OECD's Product Market Regulation (PMR) index was around the EU average before the crisis (2008). Ireland was the only country in the EU that saw its PMR score rise from 2008-13, but this is not a fair reflection of Ireland's crisis response. The rise in Ireland's PMR score was linked to the necessary bailout and nationalisation of banks. The 2013 PMR score also does not fully reflect all the reforms Ireland made by the end of the programme.



Source: European Commission



Source: European Commission



Source: Eurostat

Reforms to wage setting aimed to help the cost of employing lower-skilled workers adjust to the post-crisis reality. In the run-up to the crisis, private and public wage growth outstripped productivity, undermining competitiveness⁽¹⁷⁵⁾. By the time Ireland asked for financial assistance in 2010, a significant downward adjustment of the Real Effective Exchange Rate (REER) (Graph 7.1a) had already taken place, but the Irish National Minimum Wage (NMW) of €8.65 was still the second highest in the EU. In a context of high low-skilled unemployment and falling prices and real wages, the MoU included a planned reduction of the hourly NMW by €1. Irish stakeholders were divided on whether the level of the NMW was really a barrier to hiring. The OECD had also called for the minimum wage to be reduced⁽¹⁷⁶⁾ and on balance this measure was justifiable. Some economic sectors were covered by Employment Regulation Orders (EROs) and Registered Employment Agreements (REAs), which set higher pay minima and in some cases also non-pay conditions. These wage rigidities risked being a barrier to post-crisis adjustment and there was a consensus among most Irish stakeholders that reform was needed. For example, wage floors in construction remained high despite a sharp fall in labour demand. The MoU included a provision that the sectoral wage bargaining system should be reformed following an independent review. No measures relating to Employment Protection Legislation (EPL) were needed because Ireland was already flexible in this respect⁽¹⁷⁷⁾.

⁽¹⁷⁵⁾ From 2000-2008 Irish Unit Labour Costs rose by over 40%, more than in any other EA country.

⁽¹⁷⁶⁾ OECD (2009) Economic Survey - Ireland

⁽¹⁷⁷⁾ OECD Employment Protection Database

The supply side labour market measures aimed to support medium-term employment growth by improving activation and skills systems. In 2010, Ireland was confronted with a combination of high and rising long term unemployment and significant skills mismatches (Graph 7.2). The construction sector alone was responsible for half the job losses. The young and low-skilled were particularly affected (¹⁷⁸). In 2009, the OECD (¹⁷⁹) detailed how Ireland's employment policies fell well short of international best practice. The MoU was in line with the OECD's recommendation of institutional reforms to unify and upgrade the delivery of welfare benefits and active labour market policies. Job seekers were to be provided with more active support to prepare or search for work, with appropriate sanctions for non-compliance. Through 2011 and 2012, conditionality became more specific with more emphasis on the early activation and re-skilling of the long-term unemployed (who by then made up 60% of all unemployment). This included the establishment and resourcing of a country-wide network of "one-stop shop" Intreo offices. OECD research on Ireland (¹⁸⁰) found the importance of education for the labour market prospects of young people had increased since the onset of the crisis. Ireland's pre-programme skills system was not sufficiently responsive to employer needs. Further Education and work-focused training were managed separately and there was a specific need to shift away from construction apprenticeships (¹⁸¹). Reforms to the FET system were only specifically mentioned from the 4th Review of the programme, with a more detailed focus from the 9th Review. There is a broad consensus that these reforms, including institutional change and moving to more evidence- and employer-based provision, were necessary and appropriate. However, they could have been emphasised sooner, particularly given that they required difficult institutional changes.

Fiscal pressures were a primary driver of measures to reform public sector wages, the health sector and network industries. The MoU envisaged further reductions in the public sector pay bill (see section 6), while respecting the 2010 Croke Park Agreement between the Irish authorities and trade unions. In the run-up to the crisis (1998-2008), real per capita health expenditure in Ireland increased by an average of 7.8% per annum, raising it to one of the highest levels in the EU (¹⁸²). Significant cuts to public health expenditure started in 2009 and continued during the first part of the programme period (¹⁸³). In July 2010, an Expert Group delivered a report on how the resource allocation and financing of Irish health care could be improved (¹⁸⁴). In 2011, the new government's 2011-2016 Programme for Government contained a commitment to an overall reform of the health service, including speedy action to curb costs and increase the efficiency of both public and private health care. In 2010, Ireland's per capita outpatient expenditure on pharmaceuticals was the highest in the EU (¹⁸⁵). The 2011-2016 Programme for Government also contained commitments to introduce reference pricing and make greater use of generics, to reduce the State's large pharmaceutical bill and costs for consumers.

In 2010, Ireland was the only country in the OECD where domestic water supplies were delivered free at the point of use. It also had a fragmented water network that suffered from under-investment, high leakage, variable water quality and occasional service disruptions (¹⁸⁶). The original MoU envisaged

⁽¹⁷⁸⁾ OECD (2013) Economic Review - Ireland

⁽¹⁷⁹⁾ OECD (2009) Economic Surveys - Ireland

⁽¹⁸⁰⁾ Kelly et al (2013) Transitions in an out of unemployment among young people in the Irish recession, OECD Economics Department Working Papers No.1084

⁽¹⁸¹⁾ Gonzales Pandiella (2013) *Getting Irish Youth on the Job Track*, OECD Economics Department Working Papers No.1101

⁽¹⁸²⁾ OECD (2010), 'Health at a Glance – Europe 2010'

⁽¹⁸³⁾ Conclusion based on information from different sources and on the basis of different metrics: OECD statistics // Ameco database // Health Service Executive Annual Reports and Financial Statements 2008 - 2013 // PA Consulting Group, 2012, 2013

⁽¹⁸⁴⁾ F. Ruane, 'Report of the Expert Group on Resource Allocation and Financing in the Health Sector' Dublin, Department of Health and Children, 2010 // ESRI, A. Brick, A. Nolan, J. O'Reilly, S. Smith, 'Resource Allocation, Financing and Sustainability in the Health Sector', Research Bulletin, 2010/3/1

⁽¹⁸⁵⁾ OECD, 'Health at a glance – Europe 2012', 2012. See also European Commission, 'Economic Adjustment Programme for Ireland – Autumn 2012 Review', 2013 // ESRI, 'Ireland: Pharmaceutical Prices, Prescribing Practices and Usage of Generics in a Comparative Context, 2013 // ESRI, 'Delivery of Pharmaceuticals in Ireland – Getting a Bigger Bang for the Buck', 2012 // European Commission, 'Cost-containment policies in public pharmaceutical spending in the EU', 2012 // "Pharmaceutical generic market share", in Health at a Glance 2013: OECD Indicators

⁽¹⁸⁶⁾ See for example OECD (2010) OECD Environmental Performance Review of Ireland; Forfas (2008) Assessment of Water and Waste Water Services for Enterprise

that by the 4th Review the government would have developed proposals for the establishment of a national water utility, with a view to introducing water charges for domestic users in 2012/13 ⁽¹⁸⁷⁾. The MoU also called for the development of plans for governance reforms and asset disposals in other network industries, principally the energy sector, with a view to improving their efficiency.

It was right to leave Ireland's existing social safety net in place, subject to targeted savings. The programme did not need to envisage fundamental changes to the relatively comprehensive and effective social safety net that already existed. It was, however, necessary to curb the unsustainable pre-crisis growth in social spending. The MoU included a commitment to reform relatively generous unemployment and social assistance benefits ⁽¹⁸⁸⁾, to make fiscal savings and improve work incentives, but avoided sharp across-the-board reductions in social support. Views differ sharply between Irish employer bodies and social organisations on whether the limited provisions in the programme around cutting and reforming welfare benefits did too little or too much in terms of delivering savings and improving work incentives. Ireland has the highest proportion of children in workless households in the EU ⁽¹⁸⁹⁾, and the causes include limited access to childcare and weak work incentives for some groups. The programme did not directly tackle this issue. On balance, it can be judged appropriate that the programme MoU was kept focussed, and did not attempt to address every one of Ireland's structural policy challenges.

Despite a generally good business environment, a number of issues that had contributed to comparatively weak competition and high price levels in parts of the Irish economy were rightly targeted. On a scale of 0 to 6, the OECD's methodology rated Ireland's pre-crisis competition regime at 2.34, the median rating in the EU15, with a weak score for the legal framework ⁽¹⁹⁰⁾. The OECD had also suggested that there were too many sectors where producers were sheltered from competition ⁽¹⁹¹⁾. High legal costs were affecting the cost structure of all business, including SMEs, and weighing on the competitiveness of the Irish economy as a whole. The European Commission's Consumer Markets Scoreboard indicated that Ireland was ranking fourth from the bottom in terms of consumer assessment of the market for legal and accountancy services. In the original MoU the Irish authorities were requested to improve the enforcement of competition law and limit exemptions from its scope. The MoU also included requirements to introduce legislation to remove restrictions to trade and competition in sheltered professions, including lawyers, doctors and pharmacists. In these sectors, prices were high and had remained so after the economic downturn. Anti-competitive practices in legal services had been flagged by the Competition Authority prior to the crisis ⁽¹⁹²⁾. The competition measures in the MoU were thus clearly justifiable.

7.2. THE IMPLEMENTATION OF THE STRUCTURAL REFORMS

7.2.1. Labour market and skills policies

The cost of employing minimum wage workers was reduced, although in a different way than initially envisaged in the MoU. The NMW of €8.65 was reduced by €1 in early 2011. Following the February 2011 general election, the new government enacted a campaign pledge to reverse the NMW reduction in July 2011. At the same time PRSI contributions were reduced from 8.5% to 4.25% for the

⁽¹⁸⁷⁾ The Programme for Government 2011-2014 included plans to introduce domestic water metering, but this was not specified in the original MoU. From the 5th Review the MoU included text on water metering, reflecting the authorities' existing plans.

⁽¹⁸⁸⁾ Government of Ireland (2010) The National Recovery Plan, 2011-14

⁽¹⁸⁹⁾ European Commission (2014) Assessment of the 2014 national reform programme and stability programme for Ireland

⁽¹⁹⁰⁾ Hoj (2007) *Competition Law and Policy Indicators for the OECD countries*, OECD Economics Department Working Paper No. 568

⁽¹⁹¹⁾ Rae et al. (2006) *Boosting Competition in Ireland*, OECD Economics Department Working Paper No.491. The main areas identified for reform included retail, pharmacies, professional services such as legal and medical services, and various network industries including electricity, telecommunications and inter-city buses.

⁽¹⁹²⁾ The Competition Authority (2006) Competition in professional services: solicitors and barristers

remainder of the programme period. This shifted the burden of reducing the cost of minimum wage labour from workers onto the Exchequer. The three institutions' willingness to allow this change was justifiable as there was a clear domestic political mandate and the core policy aim was still achieved (at a fiscal cost). By the end of the programme the nominal NMW remained the same as in 2007⁽¹⁹³⁾. It is not clear, partly due to an absence of good data, if these measures had much impact on labour demand.

Reforms to sectoral wage agreements helped to increase wage flexibility in some sectors, but were partly overtaken by judicial developments. As envisaged in the MoU, the Irish authorities carried out a review of EROs and REAs⁽¹⁹⁴⁾. The Industrial Relations (Amendment) Act was passed in 2012. This reduced the scope of EROs from 12 sectors to 6. However, by the time the Act was passed, all existing EROs had already been ruled unconstitutional by a 2011 High Court judgement. Following the programme, only a limited number of replacement EROs have actually been activated⁽¹⁹⁵⁾. Views among stakeholders were divided as to whether it is appropriate to have EROs at all given that low skilled unemployment remains high. REAs, which apply to skilled trades, were also ruled unconstitutional in 2013. From that point, only the (much lower) NMW formally applied to new hires. As a result the programme plans were partially overtaken by events. Reformed REAs should set more appropriate post-crisis pay rates for new workers, and they largely exclude non-pay conditions, though some legal uncertainty remains. Old employment contracts remain valid for existing workers, leading to some differences between the pay of old and new workers, particularly in construction. As discussed in section 6, public sector workers were subject to pay restraint throughout the programme. Nevertheless, on average public sector pay remains significantly higher than in the private sector (Graph 6.3b), even after adjusting for skills.

Much-needed active labour market policies were progressively introduced through the programme, but have taken time to become fully operational. Early in the programme, targeted reductions were made to unemployment benefit levels and eligibility. Work incentive problems remain for specific groups such as lone parents but this was not addressed in the MoU. To move to a more active welfare system, the Irish authorities needed to integrate the two agencies previously responsible for employment services and benefit delivery respectively. The "one stop shop" Intreo service was formally launched in October 2012, followed by a gradual – and ongoing – rollout of offices. The Troika initially focused on this institutional change though the effectiveness of the new active labour market policy system is primarily dependent on achieving a culture change and adequate capacity in activation services. This change represented a major challenge for the Irish authorities, particularly given limited prior expertise and a tight fiscal position. By the 6th Review, the Troika had become concerned by slow progress and the MoU conditions on the timing, evaluation and effectiveness of labour market policies became more specific. At the end of the programme, Intreo case managers were only dealing with new unemployment claimants, not the stock of long term unemployed. The flagship Pathways to Work strategy⁽¹⁹⁶⁾, launched in February 2012, was only part way to being fully resourced and effective. Caseworker/client ratios are very high, the intensity of interactions with claimants is still very low, and sanctions for non-compliance are patchy. Jobpath, under which private providers will deliver support to the long term unemployed on a payment-by-results system, is due to be rolled out in 2015.

The reforms to the FET sector have been extensive and in the right direction, although implemented with delays. Despite the importance of trying to deal quickly with skills mismatches, Ireland took a while to recognise that its existing FET system was not fit for purpose. Detail on FET reforms was only added to the MoU in the latter part of the programme, by which time relevant reforms by the

⁽¹⁹³⁾ OECD (2014) *Going for Growth 2014 Interim Report*. The relative cost of minimum wage workers in Greece and Ireland fell by more than anywhere else in the OECD (p92)

⁽¹⁹⁴⁾ Report of Independent Review of Employment Regulation Orders and Registered Employment Agreement Wage Setting Mechanisms (April 2011)

⁽¹⁹⁵⁾ In hairdressing, cleaning and security. Other sectors covered by ERO legislation do not have active agreements at the time of writing.

⁽¹⁹⁶⁾ Government of Ireland (2012) Pathways to Work – Government Policy Statement on Labour Market Activation

Irish authorities were already in train. Prior to the programme, there was no rigorous evaluation culture, resulting in limited knowledge of which parts of the system were effective or not. Given limited evidence, the Irish authorities consulted extensively on FET reforms. This was sensible but caused delays. Ireland has subsequently made progress in improving its approach to evaluation, encouraged by the three institutions. Under legislation passed in 2013, Vocational Education Centres (VECs) and FÁS training centres have formally been consolidated into 16 Education and Training Boards (ETBs). The ETBs are overseen by a new funding and monitoring institution, SOLAS. Practical implementation of the new system, including reviewing the menu of training provision, is still ongoing.

The focus on a timely and effective set of activation and FET policies could have been much sharper and more prominent from the start of the programme. The need for more effective activation and retraining policies was clear by 2010. Some measures relating to upgrading labour market policies were in the MoU from the start. Major progress was eventually made by Ireland despite the tight fiscal context. Nevertheless, these reforms do not appear to have been prioritised by the Irish authorities and they suffered delays. This slow progress has increased the risk that long term benefit claimants only start receiving proper support when they have already become detached from the labour market. In hindsight, the three institutions probably should have been more forceful in pushing for the full range of active labour market and training reforms to be set in motion as quickly as possible. Technical assistance should have been considered to facilitate this if necessary, although the view of the Irish authorities is that they did have access to the external evidence and advice that they needed.

7.2.2. Healthcare, regulated sectors and competition

The inclusion of health sector reforms in the original programme MoU could have secured more concrete results within the programme period. The possibility of bringing forward and accelerating specific, less controversial and basic actions could have been explored further. The original MoU did not specify measures relating to the health sector, with the Troika relying on the government's ability and intentions to deliver reform⁽¹⁹⁷⁾. However, as the programme progressed, difficulties in delivering budgetary savings without compromising healthcare delivery became evident⁽¹⁹⁸⁾. In particular, the urgent need for significant improvements in the financial management system was confirmed in 2012 by specific external reviews⁽¹⁹⁹⁾. In early 2013, this led to the inclusion in the MoU of measures concerning financial management and a case-based payment system for public hospitals. By the end of the programme, the Irish authorities had presented a Finance Operative Model that outlined a process to be completed by 2016, and it had committed to the introduction of the case-based payment system. This meant that key milestones were left for the post-programme period. Consequently uncertainties remained over how effective and timely the implementation would be, particularly given the potential effects of the overall health sector reforms on vested interests⁽²⁰⁰⁾ and possible adjustment fatigue⁽²⁰¹⁾. Similarly measures in eHealth were eventually included in the MoU in late 2012. While a strategy was developed

⁽¹⁹⁷⁾ Stakeholder consultation

⁽¹⁹⁸⁾ European Commission, Economic Adjustment Programme for Ireland – Reviews from Autumn 2011 to Autumn 2013 // S. Burke, S. Thomas, S. Barry, C. Keegan, 'Indicators of health system coverage and activity in Ireland during the economic crisis 2008-2014 – from 'more with less' to 'less with less'', Health Policy, volume 117, issue 3, Sept. 2014

⁽¹⁹⁹⁾ Department of Health, 'Future Health – A Strategic Framework for Reform of the Health Service 2012-2015', 2012 // PA Consulting Group, 2012 and 2013

⁽²⁰⁰⁾ Hypothesis based on information from: Comptroller and Auditor General, 'Annual Report 2008 – Accounts of the Public Services' // Department of Health and Children, 'Value for Money and Policy Review of the Economic Cost and Charges Associated with Private and Semi-Private Treatment Services in Public Hospitals', 2010 // Comptroller and Auditor General, Appropriation Accounts 2009 - 2012 // S. Thomson, E. Mossialos, London School of Economics and Political Science, 'Private health insurance in the EU', June 2009

⁽²⁰¹⁾ European Commission, 'Economic Adjustment Programme for Ireland – Autumn 2013 Review', 2013 // European Commission, 'Post-Programme Surveillance Reports – Spring 2014 and Autumn 2014 // European Commission, 'Country report Ireland 2015 – Including In-Depth Review on prevention and correction of macroeconomic imbalances' COM(2015)85 final, 26/2/2015

under the programme ⁽²⁰²⁾, key steps, including enabling legislation, were still to be implemented at the end of the programme. In the meantime, following sizeable slippages in health expenditure in 2014 amounting to about €0.7 billion (more than 0.35% of GDP), the Irish government raised the ceiling for health current expenditure for 2015 by more than €0.5 billion. Further increases of about €0.2 billion are planned by 2017 ⁽²⁰³⁾.

Ireland has made progress in containing the cost of pharmaceuticals, but the ability of measures added to the MoU late in the programme to deliver further savings mostly remains dependent on post-programme actions. As consumers negotiating with pharmaceutical companies, governments may be faced with information asymmetries and concerns about security of supplies ⁽²⁰⁴⁾. In the Irish case, the government was also faced with an industrial sector with a strong presence in the Irish economy, providing employment, investment and tax revenues ⁽²⁰⁵⁾. Before and during the programme, the Irish government autonomously took a number of actions to reduce the pharmaceutical bill, which did fall. Nevertheless, analysis suggested that there was still considerable scope for further savings ⁽²⁰⁶⁾. As a result, specific measures to increase the use of generic medicines and to review the prices of pharmaceuticals (both for in-patent and off-patent/generics) were gradually included in the MoU. These new measures were introduced in a context that had already been shaped by other Irish government actions. Actions undertaken outside the programme could have been included in the MoU to facilitate and bring forward price setting on the basis of new evidence and new rules (both for in-patent and off-patent/generics). This included new legislation concerning the pricing of pharmaceuticals (Bill published in July 2012 and enacted in May 2013). Another element is a new three-year agreement with the pharmaceutical sector covering the period from October 2012 to 2015 (signed just after presentation of the Bill and before its enactment), which introduces a rigidity to price adjustments before 2016 ⁽²⁰⁷⁾.

The Irish authorities delayed selling off state owned assets until conditions were more favourable, and necessary regulatory reforms to the energy sector had occurred. The three institutions had initially pushed hard on asset sales, but delays meant that significant proceeds were not collected during the programme period. However, it appears appropriate that the Troika accepted the Irish authorities' argument that it was better to delay sales if the proposed price was too low or there was a risk of forestalling competition in the post-divestiture industry structure. Asset sales were also not critical for meeting fiscal targets. Significant progress was made in improving the regulatory framework in the energy sector. Bord Gais Energy was eventually sold, after delays. While the reforms enacted stop short of full unbundling of the energy sector, they followed the recommendations of the independent study as envisaged in the MoU. Remaining issues in energy regulation are primarily a matter for Ireland's independent regulator.

Reforms to the water sector have gradually progressed, but the introduction of both a national utility and household water charges has been practically and politically challenging. Following an

⁽²⁰²⁾ Department of Health, *eHealth Strategy for Ireland*. Nevertheless, it has also to be considered that the EU's eHealth policy evolution can be traced back to 2004 with the first EU eHealth Action Plan. This plan called on Member States to develop eHealth roadmaps to 2010.

⁽²⁰³⁾ Department of Finance, 'Part II Expenditure Allocations 2015-2017', Department of Health, 'Statement by Minister Varadkar on the Supplementary Budget for the Department of Health', 4/12/2014, www.health.gov.ie

⁽²⁰⁴⁾ Stakeholder consultation

⁽²⁰⁵⁾ Department of Finance, S. Enright, M. Dalton, 'The Impact of the Patent Cliff on Pharma-Chem output in Ireland' Working Paper 1/2013 // IPHA, 'Pharmaceutical Healthcare – Facts and Figures', 2010 and 2012 // Stakeholder consultation

⁽²⁰⁶⁾ See ESRI, A. Brick, P.K. Gorechi, A. Nolan, 'Ireland: Pharmaceutical Prices, Prescribing Practices and Usage of Generics in a Comparative Context, 2013. On the other hand, one of the consulted stakeholders argued that an adequate level of inspection would demonstrate that Irish prices in the patent-protected pharmaceutical market are in line with other European countries as shown by an IMS Health report in 2013.

⁽²⁰⁷⁾ A mid-term review of the agreement with IPHA is foreseen. The authorities have asked for a widening of the selection of countries in the reference basket, alignment to the lowest (and not average) price and semi-annual price realignments. While the outcome of the review is not known, recent news seem to point to a refusal by IPHA of having price readjustments as part of the mid-term review of the current agreement. S. Mitchel, 'State tackles bid pharma: Emergency plan to cut drugs bill', *The Sunday Business Post*, 1/2/2015 // Stakeholder consultation // European Commission, 'Post-Programme Surveillance Report – Autumn 2014

independent assessment, as envisaged in the MoU, responsibility for water provision was transferred to a national water utility, Irish Water. Irish Water is overseen by the Commission for Energy Regulation. This should help deliver a more cost-effective service over time. However, the establishment of service level agreements between local authorities and Irish Water for an extended period is likely to limit the potential economies of scale and efficiency gains. This arrangement is being kept under review. The introduction of water charging has proven very politically contentious. The plan for compulsory water metering was set out in the Irish authorities' 2010 NRP, and in the new government's 2011 Programme for Government. These plans for metering were reflected in the MoU from the 5th Review. Given the implementation challenges, the original MoU plan to introduce charging before the end of the programme proved unrealistic. Water charging became a focus for public discontent and austerity fatigue in general. At the end of the programme, the model and level of water charging was still under discussion. On current plans, household water charges will be capped at a relatively low level until 2018, with the Exchequer continuing to meet a significant proportion of the cost of water provision.

Programme measures aimed at improving the competition law framework and ensuring adequate resourcing were implemented with some revisions, though gaps in enforcement remain. The Competition (Amendment) Act 2012 was enacted to both strengthen the enforcement of competition law, and to merge the Competition Authority with the National Consumer Agency. However, civil sanctions for breaches of competition law were not introduced, following the position of the Irish Attorney General that they would be unconstitutional. A replacement provision was introduced allowing undertakings made to the Competition Authority to be made a rule of Court, but the process is voluntary. The result was weaker enforcement than anticipated at programme inception, but this was unavoidable once the Attorney General's ruling had been made. From the 4th Review, the three institutions emphasised the importance of adequately resourcing competition enforcement. By the end of 2012, the staffing level of the Competition Authority had increased by 25% (10 people). The merged Competition and Consumer Protection Competition (CCPC) was put in place in November 2014. Overall, the actions taken are positive for the development of a more active pro-competition stance, and the programme gave a helpful push. Specifically, a number of Irish and Troika stakeholders consider the programme was important in stopping pre-programme plans to exempt additional sectors from competition law. Nevertheless, significant weaknesses remain in Ireland's framework for effectively enforcing competition rules. A recent Commission Communication on Ten Years of Regulation 1/2003 (9 July 2014) highlighted that Ireland was the only EU Member State not in a position to impose deterrent civil/administrative fines for breaches of competition law. The Irish authorities recognise the need for further action and the Law Reform Commission is undertaking a study on the imposition of civil fines.

Initial progress in reforms to increase competition in the legal services was followed by long legislative delays in a context of strong lobbying. The measures set out in the original MoU intended to move the profession away from self-regulation, towards more flexibility, competition and outside supervision. The Legal Services Regulation Bill was initially drafted and introduced in a timely way in 2011. This met the MoU condition of "introducing" legislation. However, the Bill subsequently experienced a long series of delays and has still not been enacted. There were legitimate questions about the independence of the regulatory authority in the original Bill, which meant the proposals had to be re-examined. Some provisions in the original Bill, for instance on assessing legal costs, appear to have been watered down in the face of strong industry lobbying. There is a widespread perception, including among the majority of respondents to the stakeholder consultation, that delays in legal reforms have been excessive and that the legal profession should have made more of a contribution to the adjustment process. The Troika should perhaps have been firmer in insisting on the timely implementation of meaningful reforms. This could possibly have included carving out priority aspects of the reforms for early implementation, rather than allowing specific problems to delay the whole project. In the absence of

enacted reforms, legal costs remain high ⁽²⁰⁸⁾. The OECD and the EU Council have highlighted that the measures included in the programme have not proven sufficient to adequately address wider problems in the effectiveness of the Irish judicial and licensing systems ⁽²⁰⁹⁾.

7.2.3. Assessment

The implementation of structural reforms has been less consistent than other parts of the programme, particularly in regulatory reforms that affect vested interests. Reforms to tackle both demand and supply side impediments to hiring have been broad-based but will take time to make an impact. There is a broad consensus that the reformed active labour market and skills systems represent a major improvement on the pre-programme situation. When fully operational, they should help to raise the employment rate over the medium term, particularly among young and lower-skilled workers. In terms of the issues that predate the crisis, progress on implementing regulatory reforms has been patchier, probably also due to vested interests. The relatively slow pace of reform in regulated sectors has arguably had a negative impact on the fairness of the adjustment, with disposable incomes and prices in these sectors adjusting more slowly than for lower-income workers in other parts of the private and public sectors. A more cost-effective health sector is needed to accommodate the fiscal impact of an ageing society. The programme may have missed an opportunity to deliver more fundamental reform to protected sectors, to confront vested interests and rigidities, and facilitate improved competition and efficiency among domestically-focused firms. This is due to the limited reach of the measures in the MoU, and in some cases the partial implementation of reforms.

This slow progress reflected a mix of technical, legislative and political challenges, and their relatively low perceived priority. A key reason for the mixed record is likely to be that structural reforms were not a high priority for the Irish authorities or the three institutions. The Irish authorities sensed that the European Commission did not want to spend too much political capital in this area. Structural reforms were not the main area of expertise of the IMF and ECB, and were also not in their view critical to achieving the primary fiscal and financial sector objectives of the programme. In a context of strong overall ownership by the Irish authorities, a number of conditions were phrased in terms of "introducing" (in the sense of "submitting") rather than "adopting" legislation, but this did affect the capability of the programme process to drive the completion of structural reforms. There also appears to have been relatively little up-front consideration of the increased burden linked to financial sector reforms on Ireland's capacity to drafting, passing or implementing legislation, or how this could be mitigated.

The approach of keeping the MoU light did support Irish ownership of the structural reform process. However, it also contributed to the Troika's limited capacity to tackle delays or dilutions to reforms. Overall it was positive that the MoU was largely aligned with the Irish authorities' own published plans, following a process of iteration. It was also reasonable to accommodate a measure of flexibility in the timing and means of programme implementation. Some conditions in the original MoU called for studies or did not directly specify that reforms should be implemented, or when. This strategy posed a particular risk to the delivery of reforms to complex, long-term problems that could affect vested interests, for example the legal profession. The existence of long-lasting shortfalls in the context of an economy generally perceived to be well-performing should have served as an indication as to the difficulties in effecting change. In hindsight, the three institutions could have sought to strengthen their monitoring and enforcement of structural reform conditions when confronted with mixed progress in implementation, but structural reforms were not the top priority.

⁽²⁰⁸⁾ The cost of enforcing contracts, as measured by the World Bank's Doing Business 2014 indicator, represented 26.9% of the claim. This is more than 5 percentage points above the EU average and 12pp higher than top performers such as Germany. Lawyer fees represent the majority of these costs, at 18.8%.

⁽²⁰⁹⁾ See OECD (2013) Economic Review – Ireland; EU Council (2014) Recommendation on the National Reform Programme 2014 of Ireland and delivering a Council opinion on the Stability Programme of Ireland, 2014

In a few cases, both the Irish authorities and the three institutions may have underestimated constraints and the possible benefits of technical assistance The Council Implementing Decision ⁽²¹⁰⁾ for the programme stated that "Throughout the implementation of the Programme, the Commission should provide additional policy advice and technical assistance in specific areas". Ireland did not need the type of extensive technical assistance provided to other EA programme countries. Nevertheless, from the start of the programme, there could have been more consideration of whether targeted action could have aided the timely and effective implementation of structural reforms. As discussed above, this is particularly relevant for labour market and skills policies. There was a more general need to improve the ex ante and ex post economic assessment of government policies ⁽²¹¹⁾. Several important reforms (including on legal services costs, and the establishment of a centralized credit registry) were delayed because of bottlenecks in the administration's capacity to draft legal texts ⁽²¹²⁾. This is not an area where it is easy to increase capacity, given the specific nature of the skills needed. Where legislative constraints caused delays, perhaps the approach used in insolvency reforms could have been applied more widely. In that case, one part of the reform (Examinership Light) was carved out and passed quickly as separate legislation, to avoid all parts of much-needed reforms being delayed until the complex process of passing large "omnibus" bills was completed.

In hindsight structural reforms could also have been more front-loaded. Where, as in Ireland, unemployment, fiscal consolidation measures and labour market reforms come sooner and are more significant than reforms to product markets and institutions, it tends to sharpen and prolong the negative impacts of the overall adjustment on real household incomes. It is often also more feasible to carry out unpopular but necessary structural reforms when there is a consensus on the need for urgent changes. Delays in implementing or expanding MoU structural reform conditions meant that reform fatigue set in before certain key changes were made, for example in the legal profession and health sector. Towards the end of the programme the three institutions' leverage also weakened, partly once it was clear the programme would be an overall success.

⁽²¹⁰⁾ Council of the EU (7 December 2010) Council Implementing Decision on granting Union financial assistance to Ireland, paragraph 10

⁽²¹¹⁾ *Strengthening the capacity of the Department of Finance, Report of the Independent Review Panel* (December 2010). This and other reports dating from around the start of the programme noted that the number of qualified economists in the Irish administration, particularly in the Ministry of Finance, was low by international standards.

⁽²¹²⁾ Government of Ireland (December 2014) *The Irish Authorities' Views on the Ex Post Evaluation*. Annex to IMF (2015) Ireland: Ex Post Evaluation of Exceptional Access Under the 2010 Extended Arrangement, Country Report No. 15/20.

8. MAIN MACROECONOMIC OUTCOMES AND REMAINING CHALLENGES

The EU/IMF supported programme achieved its broad objectives, which were to support the macroeconomic and financial adjustment and pave the way to sustainable growth. Ireland has recovered from the deep slump triggered by the global financial crisis and exacerbated by the ensuing banking and sovereign debt crisis. In 2014, the Irish economy grew by an estimated 4.8%. This was assisted by economic growth in major trading partners, a competitive euro exchange rate, and strong flows of inward foreign investment. Fiscal sustainability has been restored and the financial sector successfully stabilised, while structural reforms helped remove some of the market distortions remaining in the Irish economy and improved competitiveness.⁽²¹³⁾ The question is to what extent the adjustment programme has improved the prospect of sustainable long-term growth. The overall macroeconomic picture looks favourable, with relatively solid economic prospects driven by Ireland's good fundamentals. Nevertheless, substantial challenges remain. However, the legacy of the crisis, in the form of high public and private debt, will weigh on growth into the medium term.

Table 8.1:

Comparison of macroeconomic projections at the start of the programme with outturns and forecasts (y-o-y % change if not otherwise indicated)

		2008	2009	2010	2011	2012	2013	2014	2015	2016
GDP at market prices (volume)	(1)	-2.6	-6.4	-0.3	2.8	-0.3	0.2	4.8	3.6	3.5
	(2)	-3.5	-7.6	-0.2	0.9	1.9	2.5	3.0	3.0	
Domestic demand (volume)	(1)	-3.5	-9.7	-4.4	-0.7	-0.6	-0.3	3.6	3.6	3.9
	(2)	-5.0	-13.9	-4.3	-3.4	-0.7	0.4	1.4	1.5	
Exports of goods and services (volume)	(1)	-0.9	-4.0	6.2	5.5	4.7	1.1	12.6	5.6	5.4
	(2)	-0.8	-4.1	5.7	4.5	4.5	4.6	4.7	4.9	
Imports of goods and services (volume)	(1)	-2.6	-9.2	3.0	-0.6	6.9	0.6	13.2	6.0	6.1
	(2)	-2.9	-9.7	2.3	0.9	2.7	3.3	3.9	4.2	
Current Account Balance ⁽³⁾	(1)	-5.7	-3.1	0.6	0.8	1.6	4.4	6.2	5.7	5.3
	(2)	-5.0	-3.0	-0.9	1.2	2.2	2.6	3.1	3.7	
Unit labour costs (Nominal)	(1)	7.4	-2.6	-7.4	-3.2	0.5	4.2	0.8	1.2	0.9
	(2)	4.5	-3.5	-5.5	-1.5	-1.2	-0.2	0.0	0.5	
Labour productivity	(1)	-2.0	1.6	3.9	4.6	0.3	-2.1	3.0	2.0	2.0
	(2)	-2.4	0.6	3.9	1.7	1.3	1.3	1.4	1.1	
Compensation of employees per head	(1)	5.2	-1.0	-3.8	1.2	0.8	2.0	3.8	3.2	2.8
	(2)	3.4	0.0	-2.1	0.5	0.1	1.1	1.4	1.5	
Total employment	(1)	-0.6	-7.8	-4.1	-1.8	-0.6	2.4	1.7	1.6	1.5
	(2)	-1.1	-8.1	-4.0	-0.8	0.5	1.1	1.5	2.0	
Unemployment rate ⁽⁴⁾	(1)	6.4	12.0	13.9	14.7	14.7	13.1	11.3	9.6	9.2
	(2)	6.3	11.8	13.6	13.4	12.7	11.6	10.7	10.0	
Public deficit ⁽³⁾	(1)	-7.0	-13.9	-32.4	-12.7	-8.1	-5.8	-4.1	-2.8	-2.9
	(2)	-7.3	-14.4	-32.0	-10.6	-8.6	-7.5	-5.1	-2.9	
Government Gross debt ⁽³⁾	(1)	42.6	62.2	87.4	111.2	121.7	123.2	109.7	107.1	103.8
	(2)	44.3	65.5	95.0	112.4	118.7	120.5	119.1	115.5	

Notes:

(1) Actual data; forecasts for 2014-16 (May'15) - ESA 2010

(2) Programme projections at programme start (Feb'11) - ESA 1995

(3) % of GDP

(4) Eurostat definition (%)

Based on the in-depth analysis of the financial sector, the fiscal position and the structural reforms in the preceding chapters, this chapter takes a broader view and examines whether following the programme Ireland will be able to enjoy sustainable economic growth in the medium term.

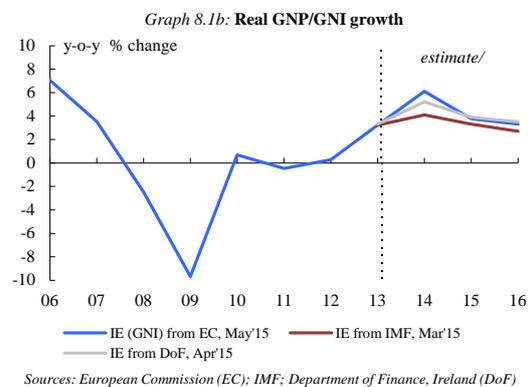
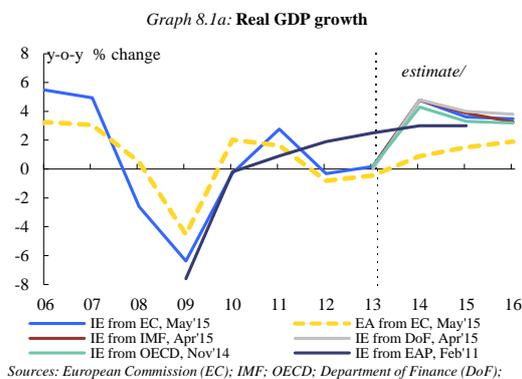
⁽²¹³⁾ See European Commission, 'European Economic Forecast – Spring 2015', *European Economy*, Vol. 2, May 2015, p. 78; European Commission, 'Macroeconomic Imbalances - Ireland 2014', 2014; IMF, 'Ireland – First Post-Program Monitoring Discussions', June 2014 and OECD, 'OECD Economic Surveys – Ireland', 2013.

8.1. AN UNEVEN RECOVERY SHAPED BY HEADWINDS AND TAILWINDS

The recovery of the Irish economy has been influenced by external factors. Credit-fuelled booms often entail deeper recessions and more protracted recoveries, as high deleveraging needs in the private and public sector shackle economic activity. ⁽²¹⁴⁾ Compared with projections made at the start of the programme, the economy stabilised and rebounded more strongly than expected in 2011, as growth in non-EU countries benefited Ireland's exports. According to figures published by the CSO, the Irish economy fell back into recession at the end of 2011. ⁽²¹⁵⁾ This was in the context of a slowing world economy and weak economic activity across the EA due to heightened uncertainty about the EU policy response to the sovereign-debt crisis (see Table 8.1). ⁽²¹⁶⁾ In 2013, the recovery was supported by the benign financial market situation, the lowering of the EFSF/EFSM margins, and the solution to the promissory note issue.

Over the programme period as a whole, net exports bolstered growth, while domestic demand was a drag on the recovery. Net exports were the main driver of GDP expansion, but the net contribution of external trade to growth was weaker than initially projected due to low growth in trading partners and the "patent cliff". ⁽²¹⁷⁾ Domestic demand remained subdued, as the government, corporate and banking sector continued deleveraging and households had to cope with a high debt burden. Additionally dented by low business and consumer sentiment, private consumption and investment contracted more than anticipated.

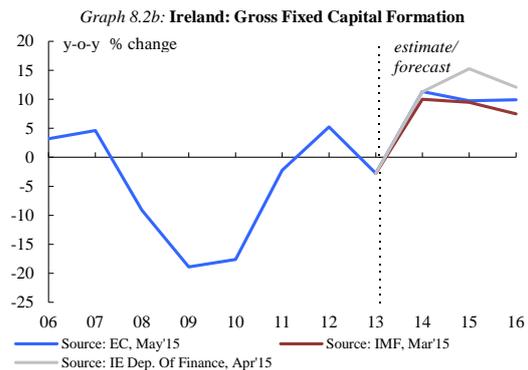
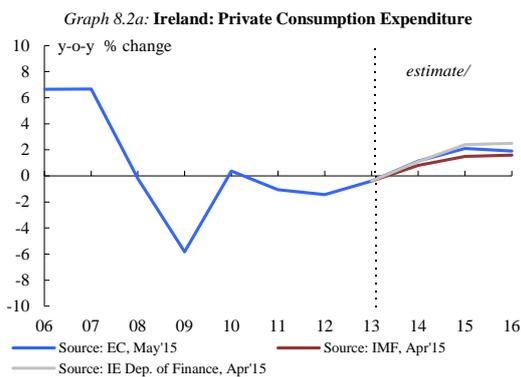
The economy has returned to growth and is set to expand robustly until the end of the forecast horizon in 2016. The Irish economy is expected to remain resilient, although with quarterly growth staying volatile. Real GDP growth in 2014 is estimated to have been 4.8%. Annual growth is forecast to hover around 3.5% in 2015-16, above the EA average (see Graph 8.1a). ⁽²¹⁸⁾ As a result of growing external and domestic demand, real output is forecast to exceed its pre-recession level in 2015.



The underlying dynamics of the domestic economy are veiled by the activity of the significant number of foreign-owned companies. Due to the traditionally large stock of FDI in Ireland, net factor

⁽²¹⁴⁾ Jordà, O. et al., 'When credit bites back', *Journal of Money, Credit and Banking*, Supplement to Vol. 45, No. 2, December 2013, pp. 3-28.
⁽²¹⁵⁾ Given the volatility of the Irish quarterly GDP and the frequency of revisions, the timing and identification of technical recessions are much less reliable than in other country cases.
⁽²¹⁶⁾ All comparisons between projections at the start of the programme in 2010 and the most recent data and estimates are subject to the constraint that the changeover from ESA 95 to ESA 2010 in September 2014 limits comparability.
⁽²¹⁷⁾ The 'patent cliff' refers to the clustering of patent expirations around few dates and an abrupt drop in sales that follows for a group of products capturing high percentage of a market, see for example Enright, S. and M. Dalton, 'The Impact of the Patent Cliff on Pharma-Chem output in Ireland', *Department of Finance Working Paper*, No. 1, 2013 and European Commission, 'Post-Programme Surveillance for Ireland – Spring 2014 Review', *European Economy*, Occasional Papers, No. 195, June 2014, p. 11.
⁽²¹⁸⁾ See European Commission (DG ECFIN), 'European Economic Forecast – Spring 2015', *European Economy*, No. 2, May 2015, pp. 78.

incomes, i.e. interest and dividend earnings on the economy's net foreign assets, play an important role and lead to a significant difference between national and domestic output, i.e. between gross national income (GNI) and gross national product (GDP). GNI strips out the impact of income repatriated to non-residents from the large foreign-owned multi-national companies (MNCs) and thus appears the more appropriate metric for assessing the Irish domestic economy. In fact, GNI suggests a smoother and more gradual recovery than GDP. Starting from 2011, when it declined by 0.5%, GNI increased without interruption and is forecast to expand closely in line with GDP in 2015-16 (see Graph 8.1b).



Due to the legacy of the crisis, domestic demand was a drag on growth during the programme. Owing to depressed disposable incomes and high unemployment, private consumption contracted throughout the programme (Graph 8.2a). In contrast, private investment (including construction) was more volatile, mainly due to the influence of aircraft purchases and intellectual property deals by MNCs (see Graph 8.2b). Investment is expected to grow solidly over the forecast period.⁽²¹⁹⁾ In 2014, domestic demand is estimated to have expanded for the first time since 2007. It is expected to contribute more to GDP growth than net exports in 2015 and 2016 (Graph 8.3a).⁽²²⁰⁾

Overall, the recovery was weaker than programmed, but substantially stronger than in peer countries. The Irish economy was well positioned to profit from the global recovery and somewhat decouple from the business-cycle dynamics in the EA. Ireland is a flexible, open economy and it benefitted from its strong trade links with the UK and US markets throughout the programme. As a result, Irish GDP growth over the programme period outpaced both the EA average and growth in other programme countries (see Graph 8.3b).

Domestic demand is taking over from net trade as the major driver of GDP growth. The combined effect of rising employment and wages, falling energy prices, and a declining household savings rate, should support disposable incomes and hence private consumption⁽²²¹⁾. Improved business and consumer sentiment, other short-term indicators⁽²²²⁾, and higher tax revenues⁽²²³⁾ add to this positive picture (see

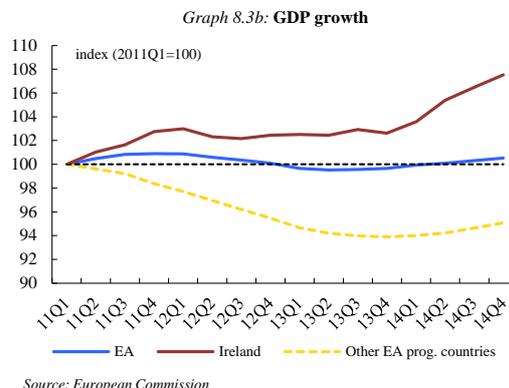
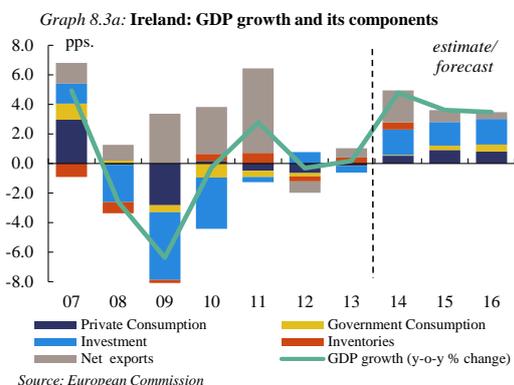
⁽²¹⁹⁾ See European Commission, 'European Economic Forecast – Spring 2015', *European Economy*, Vol. 2, May 2015, p. 78 and OECD, *OECD Economic Outlook*, Vol. 2014/2, 2014.

⁽²²⁰⁾ See Department of Finance, 'Budget 2015- Economic and Fiscal Outlook' and OECD, 'OECD Economic Outlook', Vol. 2014/2.

⁽²²¹⁾ Gross disposable income of households is estimated to have decreased in 2014, but is expected to rise in 2015-16. In addition, an increasing average remuneration per employee – at least partly due to longer working hours – should further support disposable income, see IMF, 'Second Post-Program monitoring discussions – Ireland', December 2014.

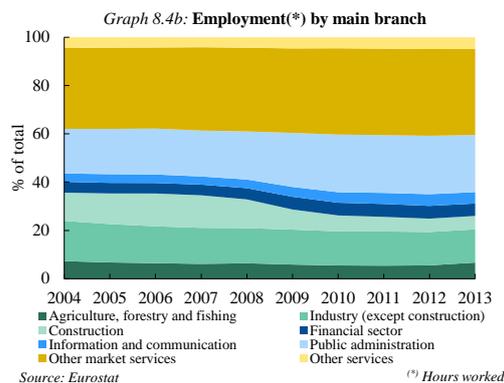
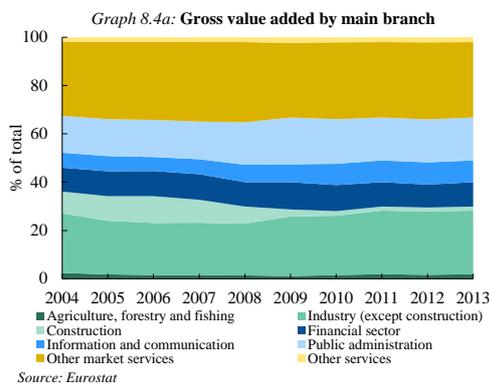
⁽²²²⁾ According to DG ECFIN's Business and Consumer surveys, consumer confidence is improving since July 2014 (except for November 2014 and March 2015), while retail sales have been on a positive trend during 2014, both including and excluding motor trades (CSO Ireland). The Investec manufacturing purchasing managers' index (PMI), the Investec Services PMI (Markit Economics, April 2015) and the Ulster Bank Construction PMI (Ulster Bank, March 2015) keep on suggesting improvements in business conditions. Industrial production has significantly increased in annual terms every month in 2014 (except June) (CSO Ireland). Nevertheless, after steady increases since 2013, the SME Business Confidence and Expectations Index has deteriorated during Q1 2015 (Irish SME Association, April 2015).

⁽²²³⁾ In the year up to December 2014, VAT receipts, excise duties and income tax receipts were ahead of targets, see European Commission, 'Post-Programme Surveillance Report – Autumn 2014'.



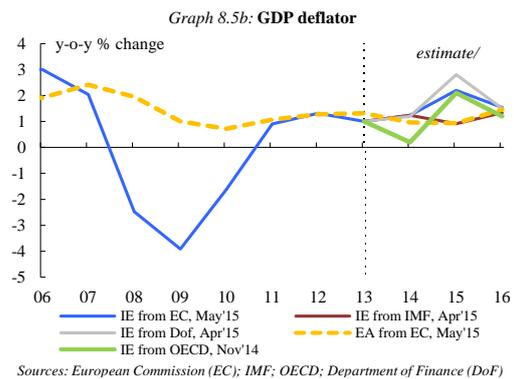
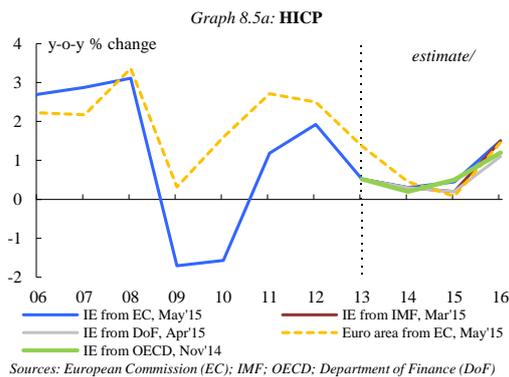
Graphs 8.2a and 8.2b). Moreover, net exports are expected to contribute positively to GDP growth, despite accelerating import growth in line with domestic demand dynamics. But the pick-up in domestic demand suggests that successful deleveraging allows households and companies to gradually increase consumer spending and investment outlays respectively. The Irish growth model is unlikely to change fundamentally, but GDP growth is expected to become more balanced over the forecast horizon.

The rebalancing of the Irish economy, which had started prior to the programme, was accompanied by a sharp rise in unemployment. Structurally lower housing demand, an impaired banking system and a general reassessment of financial risk implied a relative decline of the construction and financial sectors, albeit at a different pace. According to Eurostat data (see Graph 8.4a), gross value added in the construction sector plummeted both in absolute and relative terms, mostly before the programme. In contrast, the share of gross value added of the financial sector (including insurance) only started to decline in 2010. The share of gross value added in public administration (including defence, education, health and social work) also started to fall only around the time of programme inception (late 2010). By contrast, the share of gross value added in the manufacturing sector rebounded in 2009 and improved further at the beginning of the programme period. It is also noteworthy that components of market services, notably 'Information and communication' gradually increased their share throughout the programme. Taking a look at sectorial employment, the construction sector was at the forefront of initial adjustment (see Graph 8.4b).



Following substantial price adjustment before the programme, consumer-price inflation remained muted in the face of subdued wage pressures and weak domestic demand. Reflecting the slump of domestic demand, Harmonised Index of Consumer Prices (HICP) inflation plummeted between 2009 and 2010 (see Graph 8.5a). The same dynamics, albeit more pronounced, are exhibited by the GDP deflator. This excludes import prices and indirect taxes and is thus a better measure to gauge domestic price dynamics. Most of the necessary price adjustment had already occurred prior to the programme,

mitigating the need for further adjustment thereafter (see Graph 8.5b). Price pressures remained subdued over the programme. In the coming years rising demand should dispel deflationary concerns and keep inflation around the EA average. ⁽²²⁴⁾ Residential property prices are now increasing (more in Dublin than in the rest of Ireland). Nevertheless, the number of property transactions is still low and the national property price index remains 38% below its 2007 peak. Supply constraints might exert upward price pressures, but construction appears to be picking up. In addition, macro-prudential measures to prevent the building up of housing bubbles are expected to limit excessive price increases in the future. ⁽²²⁵⁾

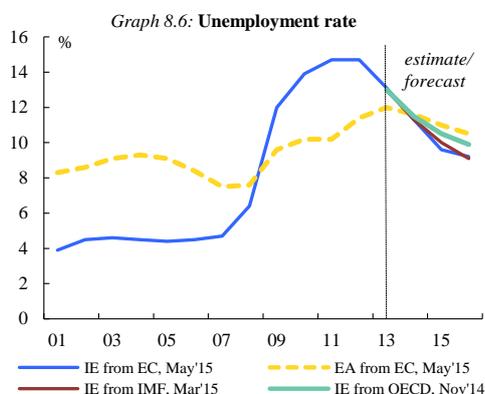


Unemployment responded quickly to the onset of the crisis, but wage flexibility and labour mobility prevented a worse labour market performance. Between 2008 and 2010, the unemployment rate surged from 6.4% to 13.9%. The construction sector lost more than 60% of its workforce, mostly in the three years before the programme (see Graph 8.4b). The large number of former construction workers could not be immediately absorbed by other sectors. Much of the initial adjustment occurred through an increase in unemployment and emigration. Against expectations at the start of the programme, the unemployment rate continued to rise, reaching 14.7% both in 2011 and 2012. In 2012, this was two percentage points higher than initially forecast, and was combined with a further contraction of the labour force and a lower participation rate. Besides the usual delay in the response of employment to changes in the level of economic activity, one important reason for the continued deterioration of the labour market in 2011-12 was that the export sector was the dominant engine of growth. This sector tends to be less job-intensive so could not quickly compensate for employment losses in other more labour-intensive sectors such as construction. ⁽²²⁶⁾ In 2013, the unemployment rate decreased substantially, although real GDP only expanded by 0.2% and outward migration was beginning to decline. In 2014, unemployment is estimated to have fallen below the EA average, to levels last witnessed in 2009. Over the forecast horizon, a further sustained decrease in unemployment is projected (see Graph 8.6).

⁽²²⁴⁾ Considering the fall of oil prices, the HCPI for energy is estimated to have remarkably decreased in 2014 and this phenomenon is even expected to accentuate in 2015 before reverting in 2016. Net of this effect (and unprocessed food), prices growth is estimated for 2014 and projected for 2015 around 0.8% before reaching 1.2%. European Commission, Ameco database, May 2015.

⁽²²⁵⁾ See European Commission, 'Post-Programme Surveillance Report – Autumn 2014 and IMF, Second Post-Program monitoring discussions – Ireland, December 2014.

⁽²²⁶⁾ European Commission, 'The economic adjustment programme for Ireland – Winter 2011 Review'



Likewise, employment growth turned positive in 2013 and is expected to stay at around 1.5% per year until 2016. These developments demonstrate the underlying flexibility of the Irish economy. In addition, structural reforms introduced under the programme – addressing both demand side (wage-setting) and supply side (activation, skills and work incentives) deficiencies – should further support sustainable employment and economic growth (see section 7.2).⁽²²⁷⁾ However, long-term unemployment and youth joblessness, remain serious challenges. The rebalancing of the economy lowered demand for low-skilled workers and exacerbated skill mismatches. Long-term unemployment has been falling since 2013 but remains at 46% of all unemployment benefit claimants, while the youth unemployment rate was still 23.9% in 2014. Hence, there remains a risk that some cyclical unemployment becomes structural.⁽²²⁸⁾

The economic crisis caused significant hardship in Irish society, but Ireland's social safety net protected the most vulnerable. In a difficult fiscal context, Ireland's social safety net has been relatively successful at cushioning the impact of rising unemployment, falling wages and austerity measures on poverty levels. Following the sharp rise in unemployment, half of all Irish households would be at risk of poverty without social transfers. However, following redistribution, the poverty rate was only 15.2% in 2013⁽²²⁹⁾. The relative poverty indicator is slightly misleading given that it is measured as a ratio of median incomes, which have fallen significantly⁽²³⁰⁾. The material deprivation indicator has risen sharply since the crisis hit, from 11.8% in 2007 to 22.6% in 2010 and 30.5% in 2013. The main income inequality indicators, the Gini coefficient and quintile share ratio, have remained stable over the programme period and were in 2013 also little changed from pre-crisis levels⁽²³¹⁾.

The burden of fiscal adjustment was shared quite widely, though overall the younger generations were hit harder by the crisis. Micro-simulations based on the EU partial equilibrium model EUROMOD, the Irish national model SWITCH and the ESRI tax-benefit model all find that the burden of the fiscal adjustment was quite evenly distributed across the income distribution⁽²³²⁾, when measured as a proportion of disposable income. Welfare benefit reductions hit the poorest households hardest, while tax rises and public pay restraint were behind the larger income reductions for the richest decile. Young adults have seen the sharpest decrease in their standard of living, in a context of high youth unemployment, increases in university fees, and reductions in unemployment benefit rates. In contrast,

⁽²²⁷⁾ European Commission, 'Macroeconomic Imbalances – Ireland 2014', 2014

⁽²²⁸⁾ European Commission, 'Country report Ireland 2015 – Including an In-Depth Review on the prevention and correction of macroeconomic imbalances' COM(2015)85 final, 26/2/2015.

⁽²²⁹⁾ SILC (2014)

⁽²³⁰⁾ Median real equalised disposable income per individual fell from EUR 19,273 in 2010 to EUR 17,374 in 2013, a decrease of nearly 10%.

⁽²³¹⁾ SILC (2014). The Gini coefficient was 0.314 in 2010 and 0.313 in 2013. The Income quintile share ratio was 4.8 in both 2010 and 2013.

⁽²³²⁾ Keane, C., *et al.* (2012). Identifying Policy Impacts in the Crisis: Microsimulation Evidence on Tax and Welfare Callan, T., *et al.* (2012) Budget 2013: Distributional Impact

people over 65 years saw the smallest decrease in median income, and their deprivation rate is now 20% points lower than that for young people⁽²³³⁾. Ireland has an exceptionally high proportion of children living in workless households (See Section 7), which is reflected in the proportion of children experiencing poverty (17.9%) and deprivation (37.3%) in 2013⁽²³⁴⁾ being above the average for the population as a whole.

Given the importance of fair burden sharing in maintaining public support for the programme, distributional issues could have been more clearly, explicitly and systematically addressed. The distributional impact of austerity measures was only periodically addressed in the programme reviews,⁽²³⁵⁾ In discussions on the original MoU, the Troika partners and Irish authorities took into account the importance of ensuring that the burden of adjustment was distributed fairly, but this was not always made clear and explicit. Only in the last programme review was fair burden sharing stated as important for the sustainability of the adjustment strategy.

8.2. INTERNAL AND EXTERNAL ADJUSTMENT

The different areas of programme conditionality had the common objective of reducing external and internal imbalances, while financial assistance was provided to smooth the adjustment process.

As a member of a currency union, Ireland could not resort to a nominal depreciation of its currency. It had (and still has) to adjust by means of internal devaluation, i.e. by decreasing prices and wages relative to its peers. This increase in external competitiveness has to be accompanied by a shift in relative prices (tradable goods vs. non-tradable goods) to induce a reallocation of resources to more productive sectors of the economy (i.e. from the non-tradable to the tradable sector). Price competitiveness is reflected by unit labour cost, which can be decreased by cutting wages and other production costs and/or by lifting productivity. If it is driven by falling prices and wages, the flipside of improved competitiveness is a higher real debt burden. This tends to hamper the deleveraging process. In contrast, fiscal consolidation and private sector balance-sheet repair are less painful if gains in competitiveness are mainly driven by productivity gains. The aim of this chapter is to shed some light on the underlying drivers of the recent recovery, and to disentangle the underlying trends of internal devaluation and rebalancing.

The current account balance has shifted into a surplus. A strong export performance is expected to generate significant surpluses in 2015-16 (see Graph 8.7a). In 2011, a significant improvement in net exports was matched by a substantial deterioration of the negative balance of primary income. In both 2012 and 2013, growth in net exports of goods and services was much slower than the initial projections in the programme⁽²³⁶⁾. This was due in part to the slowdown in Ireland's main trading partners and the so-called patent cliff in the pharmaceutical sector.⁽²³⁷⁾

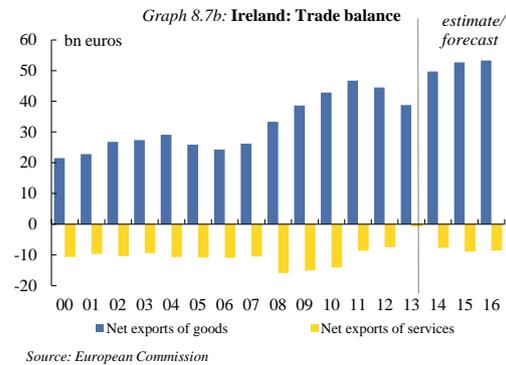
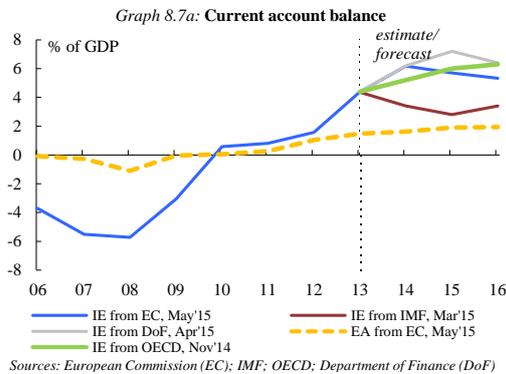
⁽²³³⁾ Idem

⁽²³⁴⁾ Idem

⁽²³⁵⁾ The distributional impacts of the austerity measures were addressed in the 4th, 8th and 10th programme reviews.

⁽²³⁶⁾ Initial projections concerning the increase of the external balance of goods and services in 2012 and 2013 were about 13% and 10% respectively, but it remained around only 2% in both years. European Commission, Ameco database, May 2015

⁽²³⁷⁾ European Commission, "The economic adjustment programme for Ireland" Autumn 2011 and Autumn 2012 Reviews.

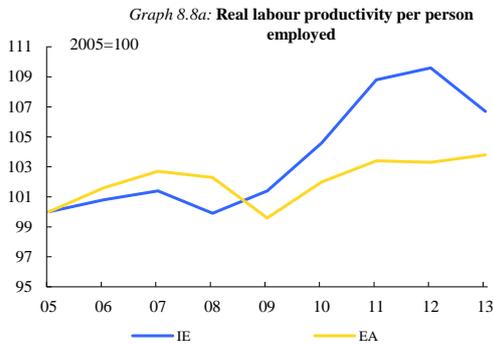


In 2013, moderate growth in net exports continued. The negative balance of primary income improved sharply, leading to a significant current account surplus of 4.4% of GDP. ⁽²³⁸⁾ In 2014, net exports have been boosted by rapid increases in contract manufacturing. This may be mostly linked to the activities of MNCs and could prove to be temporary, with a limited impact on long term employment. ⁽²³⁹⁾ From 2009 to 2013 net service export position has consistently improved ⁽²⁴⁰⁾. In 2012 and 2013 this also compensated for decelerating and then falling net goods exports (see Graph 8.7b). The strong performance of net exports is not only due to a fall in imports due to the recession; imports actually increased during the programme period. ⁽²⁴¹⁾

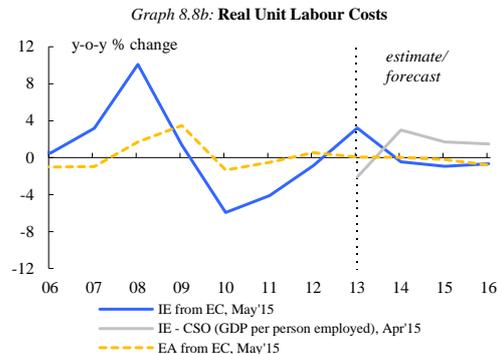
Improvements in productivity and cost-competitiveness started before the programme and continued thereafter. When employment began to decrease after 2008, labour productivity started to rebound. Moreover, the employment losses in the labour-intensive and relatively unproductive construction sector helped lift productivity also in terms of hours worked (see Graph 8.8a). However, it is worth mentioning that wage rates in the private sector have remained largely stable, while labour costs have increased among Ireland's trading partners. ⁽²⁴²⁾ Helped by the reduction of PRSI contributions, hourly labour cost growth in Ireland has constantly been lower than the EA as a whole since the onset of the crisis. The hourly labour cost index showed a year on year decrease in all quarters of 2014 (Eurostat, May 2015); reforms to wage setting may be contributing to this development (see also section 7). Nevertheless, recent developments suggest upward pressure on wages. Real Unit Labour Costs (RULC) fell in Ireland more than in the EA as a whole every year over the period 2010-2012 (graph 8.8b). ⁽²⁴³⁾

⁽²³⁸⁾ European Commission, Ameco database, May, 2015
⁽²³⁹⁾ Contracted production occurs when an Irish-resident (though not necessarily Irish-owned) enterprise contracts a plant abroad to produce a good for supply to a third country. Irish Fiscal Advisory Council, 'Fiscal Assessment Report', November 2014 // Ireland, 'Budget 2015 – Economic and Fiscal Outlook'
⁽²⁴⁰⁾ As large MNCs have increasingly used Ireland as a base of providing ICT, business and financial services (offshore financial services are a strong generator of net exports). In 2009 net exports of services were about -9% of GDP while in 2013 they were close to balance, notwithstanding imports of services also increased, including raising payments for royalties and licences. (European Commission, 'Country report Ireland 2015 – Including an In-Depth Review on the prevention and correction of macroeconomic imbalances' COM(2015)85 final, 26/2/2015) Estimates for 2014 and projections for 2015 and 2016 suggest that net exports of services are now turning negative again (Ameco database, May 2015). Also contracted manufacturing may be contributing to this development as long as contracted production is recorded as importation of services (see above).
⁽²⁴¹⁾ During the programme period, net exports increased by about 33% in real terms, to reach about 22.5% of GDP (compared to 17.5% in 2010). While exports of goods were stable, export of services increased by about 27% (from €68 to €86 bn). Imports of goods and services also increased by about 7% (from €129 billion to €138 billion). (European Commission, Ameco database, May 2015)
⁽²⁴²⁾ See O'Farrell, R., Wages and Ireland's international competitiveness, *NERI Working Paper*, No. 2013/No 7, November 2013.
⁽²⁴³⁾ Then there was a temporary increase in 2013, probably due to the composition of employment growth and the so-called patent cliff. The RULC is the average cost of labour per unit of output. The deterioration recorded in 2013 reflected the composition of employment growth as the economy recovered with job growth occurring mainly in low productivity sectors (CBI, 'Quarterly Bulletin 04', October 2014) and also the effect of the patent cliff in the pharmaceutical sector (Ireland, 'Budget 2015 – Economic and Fiscal Outlook'). It seems to be reasonable that the reduction in proceeds caused by the patent cliff to the pharmaceutical industry may be an important factor behind the deterioration of labour productivity in 2013. This consideration may be reinforced by the hypothesis that the patent cliff should not have led to a sudden fall in cost of labour or number of persons employed proportional to the fall in proceeds.

The bulk of the adjustment in employment and salaries has already occurred, although further moderate falls in RULC are expected in 2015 and 2016.⁽²⁴⁴⁾ The REER (on a ULC basis) has also fallen significantly (see also section 7 and graph 7.1a). All these dynamics should support export growth.

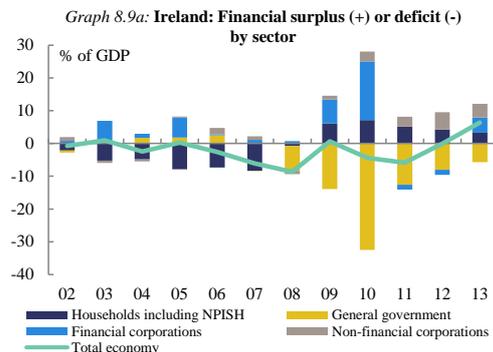


Source: Eurostat

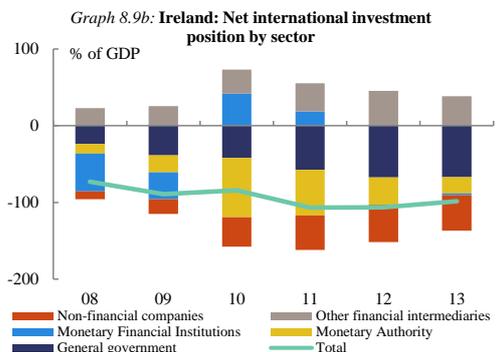


Sources: European Commission (EC); Department of Finance (DoF)

Deleveraging and balance-sheet adjustment have been substantial, but debt levels remain high. The public sector managed to reduce its net borrowing, while the private sector moved into a surplus position. The result is that the Irish economy as a whole became a net lender to the rest of the world in 2013. This is particularly true for private households and non-financial corporations which have been aggregate net lenders since 2009 (see Graph 8.9a). The government reduced net borrowing considerably over the programme, even though it was forced to take on a substantial debt burden due to the rescue of the domestic banking sector prior to the programme. However, this favourable development in terms of flows is not yet reflected in stocks. Ireland's net international investment position still showed net liabilities of around 100% of GDP in 2013. While the CBI gradually decreased its liabilities vis-à-vis the Eurosystem, the Irish government and non-financial corporations only stabilised their debt position against the rest of the world. This implies that both the government and business sectors still face substantial deleveraging needs (see Graph 8.9b and also Box 8.1).



Source: European Commission



Sources: European Commission, Central Statistics Office, Ireland (CSO)

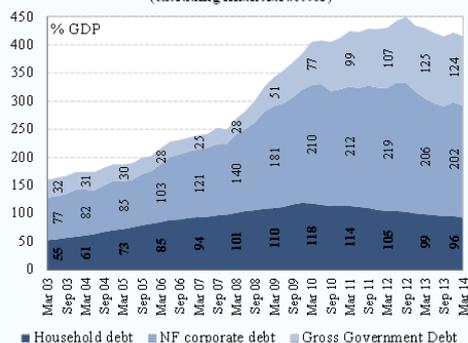
⁽²⁴⁴⁾ CBI, 'Quarterly Bulletin 04', October 2014.

Box 8.1: Deleveraging of the Irish economy and macroeconomic adjustment

At the outset of the financial crisis, the private sector in Ireland was already highly indebted. During the housing boom, fiscal incentives and lax credit standards allowed for easy financing conditions, fuelling an unsustainable accumulation of debt in the private sector. In particular, the ratio of household debt to disposable income rose from approximately 95% to 208% during the period 2001-08. By the end of 2008, private sector debt had reached 282% of GDP, up from 143% five years before, while public debt was still relatively low, corresponding to 44% of GDP.

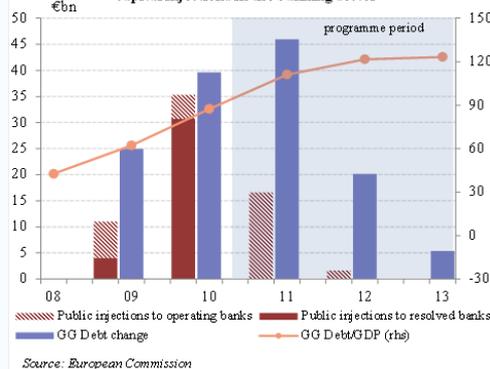
In the two years leading to the programme, private debt continued to increase, accompanied by a surge in public debt. Due to the already high debt levels at the outset of the crisis the private sector was ill-prepared when the economic crisis struck and unemployment started to rise in 2008. Automatic stabilisers and discretionary policy measures induced a partial shift of the debt burden to the public sector which attempted to stave off further damage from the economy. Between 2008 and 2010, public debt increased by an additional €46 billion as the government was forced to stabilise an ailing banking system that was on the brink of collapse (see Graph 1a and 1b). Those funds, which were largely deemed non-recoverable⁽¹⁾, added to the fiscal deficit and public debt rose to 91% of GDP by the end of 2010. At the same time, private sector debt continued to increase to 321% of GDP.

Graph 1a: Ireland: Evolution of public and private debt (excluding financial sector)



Sources: ECB, national account data (CBI)

Graph 1b: Ireland: Evolution of public debt and public capital injections in the banking sector



Source: European Commission

During the programme, deleveraging in the private sector gained momentum. Consolidated household debt has continuously declined from the peak of 119% of GDP at the end of 2009 to 95% by the end of 2014 against the backdrop of contracting disposable incomes.⁽²⁾ The prevalence of tracker mortgages probably supported deleveraging by reducing the debt service burden of Irish households, which is now below the euro area average. In contrast, non-financial corporate debt hardly changed over the programme period and stood at around 210% of GDP at the end of 2013, albeit 19% lower than the peak in the first half of 2012. However, a large share of non-financial corporate debt is likely to be associated with multinationals, which are mostly financed through intra-company loans (i.e. non-resident funding). As outstanding credit provided by domestic banks and other financial institutions, including NAMA, to non-financial corporates decreased during the programme, it is plausible that domestic corporates have reduced their debt levels earlier and more than suggested by aggregate data.

But public debt increased, leaving total debt still at high levels when the programme ended. During the programme, debt migration from the private to the public sector has continued, although at a much slower pace than before. Public debt stood at 120% of GDP at the end of the programme, up from 91% in 2010. Overall, despite substantial progress, the combination of private and public sector

⁽¹⁾ See Minister of Finance announcement ‘Minister’s statement on banking matters’ and annexed FAQ of 30 March 2011, <http://www.finance.gov.ie/ga/news-centre/press-releases/minister%E2%80%99s-statement-banking-matters>
⁽²⁾ In order to achieve an effective resolution of mortgage arrears, some banks offered partial debt relief to distressed mortgage holders, which also helped reduce household indebtedness.

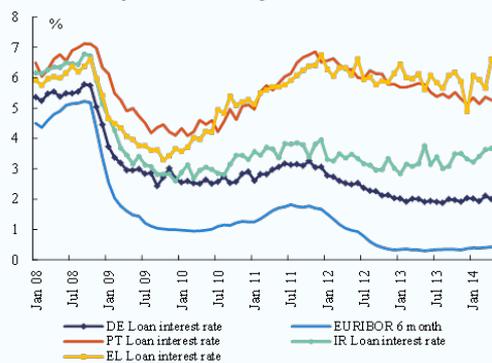
(Continued on the next page)

Box (continued)

debt remains high in Ireland, at around 400% of GDP, with both debt components exceeding the threshold values under the EU's Macroeconomic Imbalance Procedures. ⁽³⁾

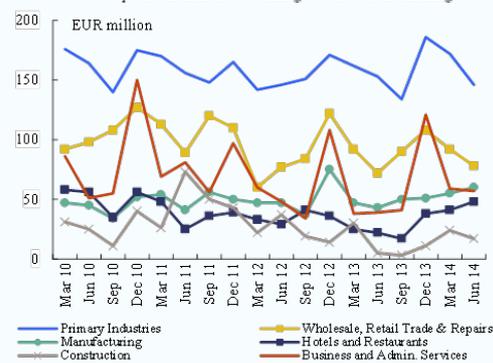
Despite the need for deleveraging, the provision of credit to viable businesses is essential for macroeconomic adjustment and rebalancing. The necessary change in the production structure and the shift of productive resources to the tradable sector require investment in equipment, mostly by SMEs. However, new gross lending to SME has remained relatively muted, with SMEs in the service industry being more affected. ⁽⁴⁾ Even though average relatively low and stable interest rates were maintained for loans, the interest rate premium has increased significantly for smaller borrowers and is now above the EA average. ⁽⁵⁾ This might be explained by differences in creditworthiness of large and small borrowers or by a more adequate risk pricing by lenders. ECB and CBI surveys on the access to finance of SMEs point to weak credit demand as a major factor behind subdued loan growth. Credit demand tends to be rather associated with the financing of working capital and restructuring needs than with capital-widening investment, although the situation is gradually changing. ⁽⁶⁾ Looking on the supply side, the still high level of NPLs held by banks is an additional limiting factor for credit supply which still requires effective resolution.

Graph 2a: Interest charged on new short-term loans



Source: ECB

Graph 2b: Ireland: Sectorial gross new SME lending



Source: national account data (CBI)

Balance-sheet recessions tend to be protracted and are followed by a subdued recovery. Past economic cycles suggests that episodes of over-borrowing are followed by protracted periods of deleveraging, often triggered by a banking crisis. ⁽⁷⁾ Combined with uncertainty about the macroeconomic situation and asset quality as well as adverse credit conditions, the ensuing balance-sheet repair is weighing on growth, at least in the short term. Therefore, balance-sheet recessions tend to be characterised by deeper downturns as well as shallower recoveries and are often associated with substantial and permanent output losses. Given the flexibility and openness of the Irish economy, however, ongoing rebalancing in Ireland is likely to stifle growth less than in other Member States faced with substantial economic adjustment. For example, both private consumption and investment are set to increase over the forecast horizon 2015-16, while private households are expected to reduce net savings. However, the level of indebtedness of the private sector remains high and will require corporates and households to repay debt and strengthen their balance sheets. ⁽⁸⁾ The resulting output losses are difficult to quantify, since potential growth was likely to be overestimated prior to the crisis, but the Irish economy is rather unlikely to return to the pre-crisis growth path. ⁽⁹⁾

⁽³⁾ See 'Macroeconomic Imbalances – Ireland 2014' – and 'Country Report Ireland 2015'.

⁽⁴⁾ For example the "hotel and restaurants" sector, which is also among the sectors with the highest rates of loan defaults.

⁽⁵⁾ See CBI, SME Market Report, 2014.

⁽⁶⁾ See ECB, Survey on the access to finance of enterprises (SAFE), April 2014 – September 2014, November 2014.

⁽⁷⁾ See R. Koo, *The escape from balance sheet recessions and the QE trap*, Singapore 2014 and McKinsey Global Institute, *Debt and deleveraging: The global credit bubble and its economic consequences*, January 2010.

⁽⁸⁾ For further discussion of the concept, see Cuerpo, C. et al., Private sector deleveraging in Europe, *Economic Modelling*, Vol. 44, January 2015, pp. 372-383; and Pontuch, P., Private sector deleveraging: Where do we stand?, *Quarterly Report on the Euro Area*, Vol. 13, No. 3, 2014, pp. 7-19.

⁽⁹⁾ See Borio, C., The financial cycle and macroeconomics: What have we learnt?, *BIS Working Papers*, No. 395, December 2013.

8.3. PARTLY CLOUDY – MACROECONOMIC RISKS AND MEDIUM-TERM CHALLENGES

The adjustment programme has laid the grounds for sustainable growth in the future. But even though forecasts point to solid GDP growth in 2015 and 2016, risks from economic, political and financial developments to Ireland's growth outlook and the longer-term prospects are non-negligible. Downside risks mainly concern domestic policies with the potential to undermine programme achievements as well as external factors outside the control of the Irish government. On the upside, financial conditions are exceptionally favourable and a strong implementation record of programme measures is likely to contain vulnerabilities.

Post-programme reform fatigue has the potential to jeopardise further progress. Despite some shortcomings, the programme reached the set goals and put the Irish economy on a sustainable path. This outcome was achieved by a stringent implementation of policy measures and a strong programme commitment by the Irish authorities. However, less external surveillance and low market pressure might delude policy makers that the need for change has gone; they might become less eager to institute reforms. For example, there are indications that the reform impetus in some policy areas has weakened, for example in the legal profession and health sector.

Public debt remains high and persistent spending pressure combined with potential growth shortfalls could darken the debt outlook. The budget deficit is projected to shrink further in 2014 and the level of public debt is to remain stable. But this positive outcome was mostly driven by exceptional growth which boosted tax revenues, and was also influenced by additional windfall revenues and statistical effects.⁽²⁴⁵⁾ This buoyant tax revenues are unlikely to be sustainable and a more prudent fiscal stance might be warranted for the future to safeguard fiscal sustainability. This particularly applies to expenditure which rose further at the end of 2014, mainly in the healthcare sector. Unlike in the programme period, overspending in 2014 was not offset by compensating measures elsewhere.

Deleveraging in the private sector is far from completed and is set to weigh on domestic demand. Businesses and households remain focused on debt reduction which limits credit demand and is expected to subdue private consumption and investment. A further reason for muted credit growth is the still high level of mortgage arrears in the Irish banking sector. Even though banks improved profitability in 2014, they continue to deleverage and repair their balance-sheets by unwinding the stock of NPLs, which still remains high. Yet, loan growth does not appear a constraining factor at the current juncture, given that many SMEs are able to finance investment outlays by retained earnings.⁽²⁴⁶⁾

Easy financial conditions in an environment of low interest rates could lead to complacency and increase vulnerabilities. Prior to the global financial crisis, a calm period dubbed "Great Moderation" enticed many investors and governments to embark on ever more risk-taking. Even though today the situation is different with enhanced institutional arrangements in the EA, the international search for yield might drive up asset values, especially property prices, and expose the Irish economy to the risk of a renewed housing and construction slump with the known detrimental consequences for financial stability. It also remains to be seen if programme-related reforms of financial supervision have bolstered the Irish supervisory framework sufficiently and changed old habits in a way so that domestic regulators are now better placed to lean against the wind and effectively fight asset price bubbles. Moreover, with creation of the banking union large part of responsibility has been shifted to European level and is now beyond the control of domestic regulators.

A weak economic outlook for the EA, sluggish growth in the UK and other trading partners could overshadow economic prospects. As an exporting country, the Irish economy remains especially

⁽²⁴⁵⁾ The transition from the ESA 95 to ESA 2010 methodology had a level effect on GDP.

⁽²⁴⁶⁾ See European Commission, 'European Economic Forecast – Winter 2015', *European Economy*, Vol. 1, February 2015, p. 74.

vulnerable to a slowdown on the global economy and changes in the structure of value chains and global production patterns. Ireland still depends on its capacity to attract FDI on a large scale. Given that the number of large MNCs is limited and FDI is concentrated in a few sectors (mainly pharmaceutical, software, and ICT services), Ireland is exposed to a potential shift in production networks and global demand patterns. Ireland remains dependent on the FDI sector for the bulk of export activity and a considerable share of employment. ⁽²⁴⁷⁾

Additionally, losses in competitiveness might jeopardise Ireland's role as one of the preferred destinations for EU and non-EU direct investment. FDI inflows might be influenced by potential changes to the tax regime at the global level. ⁽²⁴⁸⁾ The presence of MNCs can provide fertile ground for the development of specialised skills and expertise in high value fields. The clustering of foreign high-tech firms tend to trigger a technology transfer and eventually induce Irish domestic firms to produce goods with higher added value. This would help reduce the strong dependence on foreign firms, but it appears that Irish SMEs, after being hit harder by the crisis ⁽²⁴⁹⁾, are still not focused on expansion but on stabilising current business. ⁽²⁵⁰⁾ SMEs seem to have borne the brunt of the deleveraging in the corporate sector because they were under greater financial strain than MNCs and had to focus on loan repayments. ⁽²⁵¹⁾

⁽²⁴⁷⁾ See European Commission, 'Macroeconomic Imbalances – Ireland 2014', 2014 and McKinsey Global Institute, 'Capturing the value of Ireland's global connections', 2014 and Department of the Taoiseach, 'Draft National Risk Assessment 2014', April 2014 and Department of Finance, 'Budget 2015 – Economic and Fiscal Outlook'.

⁽²⁴⁸⁾ Both the National Risk Assessment 2014 and the Draft National Risk Assessment 2015 acknowledge the importance of multinational companies to the Irish economy and note that whilst this reflects the success of Ireland's enterprise policy in attracting investment in these sectors, it also creates a vulnerability to changes in Ireland's attractiveness as a location for these companies. The 2014 risk assessment mentions that the possible effect of fiscal harmonization or other changes at EU or OECD level on Ireland's corporation tax regime could have a significant economy-wide impact. The risk of unfavourable international tax changes is considered in the 2015 draft risk assessment where it is mentioned that the Irish Government has signalled its commitment to the OECD's Base Erosion and Profit Shifting (BEPS) project. It is also stressed that in October 2014, the Minister for Finance published a Road Map for Ireland's Tax Competitiveness which contains ten actions to reap the benefits from a changing tax landscape. The Road Map acknowledges that the BEPS project will involve challenges but recognises that it could also offer a number of opportunities for small countries.

⁽²⁴⁹⁾ See European Commission, '2014 SBA Fact Sheet – Ireland', Enterprise and Industry, 2014, http://ec.europa.eu/enterprise/policies/sme/facts-figures-analysis/performance-review/files/countries-sheets/2014/ireland_en.pdf

⁽²⁵⁰⁾ See CBI, Quarterly Bulletin 04, October 2014.

⁽²⁵¹⁾ Corporate debt levels were reduced by paying off nominal debt and increasing the value of company assets. However, levels of indebtedness vary considerably across SME types and their respective exposure to the property market. About one quarter of all SME loans are in default, see European Commission, 'Country report Ireland 2015 – Including an In-Depth Review on the prevention and correction of macroeconomic imbalances', COM(2015)85 final, February 2015.

9. CONCLUSIONS

The Irish programme was designed to address the economic and fiscal challenges that led to Ireland losing access to market funding. The bursting of the housing bubble in 2007 caused a significant deterioration of the fiscal situation and put Irish banks in jeopardy. The financial sector's difficulties were compounded by the Lehman crisis that reverberated across the international banking sector. The economic crisis in Ireland was rooted in a pre-crisis cycle of rapid credit expansion, accelerating house-price inflation, rising consumer expenditure and a reduction in external competitiveness. A combination of strongly pro-cyclical fiscal policies, and inadequate financial regulation and prudential supervision, created the circumstances that culminated in a fully-fledged banking and sovereign crisis. Despite the introduction of substantial fiscal consolidation packages, the fiscal situation continued to worsen into 2010, largely due to the high costs of support to the banking sector. The solvency of the Irish sovereign and of the banking system became directly intertwined. On 21 November 2010, the Irish government requested financial assistance, as sovereign bond spreads surged to record highs and Ireland could not overcome the solvency crisis in its banking sector on its own.

The measures in the programme were designed to address the immediate difficulties of the Irish economy by (1) restoring viability of the financial system (2) consolidating the public finances and (3) introducing reforms that would support growth and stability over the medium term. The design of the programme also took the overall EU and EA context, and risks of contagion, into account. The involvement of the Irish authorities in the preparation of the programme was substantive and ensured their full ownership of the programme. Ireland's smooth return to financial markets, and the resumption of strong economic growth in 2014, bears witness to the overall success of the adjustment programme.

This report has examined different aspects of the design and implementation of the adjustment programme. This section summarises the findings of the evaluation and draws some lessons for the future.

Focus of conditionality (relevance)

The evaluation found that the objectives of the economic adjustment programme were relevant and that the measures included in the programme were appropriately focused. Solving the banking sector problems was key to reducing the strains on the Irish public finances and paving the way to sustainable growth. Fiscal measures were necessary given the large fiscal deficit. Though Ireland was a relatively competitive and flexible economy, cost-competitiveness had deteriorated in the run-up to the crisis. The targeted structural reforms of the programme aimed to address the direct fallout from the boom-bust cycle and tackle more long-standing economic inefficiencies.

Programme conditionality was rightly and primarily focused on financial sector reform, to restore confidence in the sector and secure its future viability. The Irish banking sector had to be stabilised and returned to a properly functioning state. This required a substantial downsizing of the sector, enhancing the resilience of viable financial institutions and beefing up the supervisory and resolution framework.

Programme conditions on fiscal consolidation and fiscal governance were necessary to close the hole in public finances and ensure sustainable fiscal policies. Even in the absence of measures to support the banking sector, the underlying fiscal deficit was sizeable. Ireland required substantial consolidation measures to slow and then reverse the large increase in public debt. Fiscal governance was strengthened, taking into account the parallel development of EU rules in this respect.

The programme contained targeted structural reforms aimed at facilitating economic adjustment and boost employment, competition and growth. The relatively limited scope of structural reform conditionality was justified by the strong fundamentals and flexibility of the Irish economy as a whole. Nevertheless, in a context of high and rising long-term unemployment and significant skills mismatches, it was right for the programme to include measures to tackle both demand side and supply side

impediments to hiring. The product market and sectoral reforms aimed to address more long-standing economic inefficiencies which held back growth, directly or via the burdens they imposed on the Exchequer and businesses. There were no other major structural reforms that should have been included in the programme.

The original programme MoU did not explicitly address the distributional impact of the adjustment measures, although interviews with both Irish authorities and staff of the three institutions concurred that distributional considerations were an intrinsic part of programme discussions. Mentioning these considerations explicitly in the MoU could have further increased the credibility of the programme and its ownership.

What has been learned: A programme MoU should reflect all aspects of policy dialogue that are important for the success of programme, including the distributional impact of adjustment measures.

Appropriateness of conditionality (design, pace, timing and flexibility)

Direct interventions into banks (e.g. bank recapitalisation, restructuring and deleveraging) were very front-loaded. In contrast, reforms to broader financial sector governance (e.g. insolvency framework and credit registry) were intended to be implemented relatively late in the programme. Given the direct impact of financial sector governance on balance sheet repair in the banks and the real economy, more rapid implementation of this aspect of the programme could have been envisaged. The reform of the personal insolvency framework was envisaged in the second half of the programme in spite of the fact that it was a crucial element of the urgent task of repairing balance sheets in both the financial sector and the real economy. Loan restructuring targets for banks were only introduced in 2013, two years after the main capital injections had been carried out. Moreover, the quick progress in the restoration of market confidence following the implementation of the most urgent bank intervention measures may have weakened the momentum for the implementation of other reforms. This includes the introduction of a credit registry to improve credit information systems.

What has been learned: Broader financial sector governance measures, including reforms to the insolvency framework, should be given a high priority. They contribute to the effectiveness of bank recapitalisation and restructuring. However, governance reforms tend to lose momentum when the immediate pressure eases. Prompt supervisory actions could help to achieve more upfront loan provisioning and restructuring, with the aim of accelerating balance sheet repair.

In the specific context of Ireland in 2010, not bailing-in unguaranteed and unsecured senior creditors was appropriate and reflecting complex considerations. There is an ongoing controversy about whether unguaranteed and unsecured senior creditors should have been bailed in. A bail-in is in theory a preferable solution, and bail-in provisions are now enshrined in the new EU regime. In 2010, however, the conditions for such a bail-in were not present in Ireland. Legal and economic risks could have undermined the effectiveness of such an action. In particular, risks of spillover to the Irish and EU financial systems were very high, especially given the absence of a proper EU bank resolution framework.

A large upfront bank recapitalisation was appropriate, in order to cover the projected losses, which were assessed through a rigorous process. The key features of the recapitalisation process under the programme were the rigorous and transparent process for assessing banks recapitalisation needs (PCAR stress test and loan assessment of 2011), and the frontloading of the ensuing injections of funds. These features were crucial for restoring confidence in the Irish banks' solvency, given the high degree of uncertainty that prevailed and in the absence of well-established firewalls at the time.

What has been learned: Ireland's problems informed the design of the new EU bank resolution framework, under which bail-in should be implemented upfront in future. This should limit the costs of

banking sector support to the State in times of crisis and encourage proper risk pricing ex ante. The capital requirements for banks under restructuring should, in any case, reflect credible assumptions on the losses yet to be realised. These losses should, in turn, be promptly recognised.

The deleveraging of the Irish financial sector was broadly appropriate in addressing vulnerabilities in the banks' funding structures in a timely manner. The deleveraging was achieved first through the resolution of two banks deemed unviable. Second, a deleveraging path was set for the remaining domestic Irish banks that had benefitted from State support, taking into account their individual circumstances. It was an explicit requirement that fire sales be avoided. Timely deleveraging allowed banks to rebalance their funding so as to rely on more stable financing sources, mainly deposits.

What has been learned: In financial sectors dependant on wholesale and other unstable sources of financing, deleveraging is an important means to address the inherent risks in the funding structure and to improve its resilience. The deleveraging process is ultimately unavoidable and should take place as soon as possible. Nevertheless, it is important that the deleveraging process does not lead to fire sales, excessive competition for deposits among banks leading to hikes in deposit interest rates, or an undue squeeze on new lending.

Not merging EBS with AIB could have provided further alternatives for the restructuring of the Irish banking sector, including PTSB. In the aftermath of the AIB-EBS merger, the concerns of the ECB and European Commission that the Irish banking sector could become a duopoly supported the decision not to resolve PTSB, despite concerns about its viability. Moreover, the immediate fiscal costs of PTSB resolution were higher than those needed for restructuring. The PTSB restructuring plan was approved in April 2015 by the European Commission under State aid rules. The bank cannot yet be seen as a forceful competitor in the Irish banking sector, but it is making progress, supported by the general recovery of the Irish economy. However, more prompt actions could have been useful to facilitate a quicker recovery of the bank's viability.

The resolution of Anglo and INBS was successfully implemented. The business model of Anglo and INBS – aggressively exposed to lending into commercial property and development – had proved unsustainable. It was decided to merge the two banks into a single group (IBRC), focused on running down its assets. In early 2013, IBRC was successfully put into liquidation. This allowed financial stability to be protected by minimising potential spillovers from the banks' legacy assets, such as loans and promissory notes.

What has been learned: Banking sector restructuring entails complex considerations about banks' viability, in a context of high uncertainty and potential spillovers. Nevertheless decisions on either resolution or restructuring should be followed by prompt and consistent actions to ensure a timely liquidation or return to viability.

Overall, the implementation of financial sector conditions was satisfactory, and flexibility was a feature. In the absence of a dedicated resolution framework and of an established tool to replace deposits and Eurosystem funding, flexibility and support from the monetary authorities allowed an orderly resolution of non-viable banks, while containing fiscal costs. The deleveraging process also benefitted from flexibility. An example is the dropping of the target on the LTD ratio when it turned out to have negative unintended consequences. Weak results in terms of balance sheet repair led to additional, albeit arguably late, targets for banks to restructure loans.

What has been learned: The contribution of programme conditions in reaching the programme's objectives should be constantly monitored. Programme requirements should remain flexible, with a view to adapting existing measures and adding new ones when required.

The overall fiscal conditionality was framed in terms of both the yield of the measures to be delivered, and of nominal targets for the overall budget deficit. The fiscal measures were appropriate, leading to a steady reduction of the deficit. Ireland met all its fiscal targets. Consolidation measures addressed the immediate hole in Irish public finances. Ireland is now on track to meet the 2015 deadline for eliminating its excessive deficit. The focus on expenditure measures, with revenues kept broadly constant as a share of GDP, was in line with the priorities of the Irish government. On the expenditure side, cuts were made to both current and capital spending, but the sharp decrease in public investment could potentially have negative repercussions for future growth. The reforms to the tax system broadened the tax base and should reduce its volatility.

Focussing the fiscal monitoring on the nominal value of the measures had strong merits, albeit with some weaknesses due to difficulties in assessing their ex post impact. Focusing on the adjustment effort lets the automatic stabilisers work freely, and in general allows negative surprises to be absorbed within the programme. The programme was prescient in monitoring reform through a bottom-up estimation of measures. The alternative was assessing changes in the structural balance, which has severe shortcomings at times of rapid economic adjustment. Nevertheless, the monitoring of the adjustment could have been strengthened if a clearer explanation on how the impact of the measures would be calculated had been set out at the start of the programme. In the Irish programme, compliance with the reform effort led to compliance with the nominal deficit targets. Had economic outcomes been less favourable this would not necessarily have been the case. It was not made clear in the programme what would have happened if there had been a conflict between the two targets.

Ireland's consistent compliance with the fiscal targets helped foster a virtuous circle of good news and credibility for the programme, underpinning the ability of the government to achieve the programme targets. The extension of the EDP deadline to 2015 ensured that the intermediate targets were achievable, with Ireland over-performing on its annual fiscal deficits during the programme. The sizeable windfall revenues from a lowering of EFSF/EFSM interest rates represented an implicit easing of the fiscal targets but led neither to a downward adjustment in the financing envelope, nor to an adjustment in fiscal targets.

Overall, the degree of frontloading of fiscal consolidation, as evidenced by the impact of the measures introduced as agreed in the programme, seems appropriate. While the change in the structural balance points to a back-loaded consolidation, the bottom-up measurement points to a front-loaded fiscal effort. In view of the unexpectedly high GDP growth in 2011, it is difficult to argue that it would have been better to backload the consolidation. In contrast, the different profile of GNI growth and the continued increase in unemployment into 2012 suggest there might have been more of a case for sharing the adjustment effort more uniformly over the programme period. Nevertheless, when considering the confidence benefits of having taken the most difficult steps by 2011, and the strong GNI growth that followed, on balance the consolidation profiling decisions taken in late 2010 have stood the test of time well. Moreover, the Ireland's headline deficit was still high when it exited the programme, leaving substantial consolidation efforts to be made in the post-programme period. It also made sense to continue with the strong adjustment process that had already started over 2008 and 2009, rather than to reduce the adjustment effort in the middle of the consolidation process.

What has been learned: Achievable fiscal targets can lead to a virtuous circle of good news and credibility for the programme. Frontloaded fiscal consolidation allows the brunt of the impact to be introduced when the importance of adjustment is well understood and helps underpin a strong return of market confidence. Nevertheless, it needs to be done with due consideration of the implications for growth and unemployment. Care should be taken to be explicit in how the consolidation effort will be measured in a programme context. Measuring the effort made according to the impact of the measures may have strong merits, but is not without its own measurement issues. Being explicit about these measurement issues at the start of the programme can help add credibility to it.

The structural reform content of the programme was broadly appropriate. On the one hand, the expansion of the scope and detail of structural measures in the course of the programme showed its flexibility. On the other hand, in some cases (for example FET and health reforms) measures could have been identified, included and progressed at an earlier stage. A timely start on structural measures is important, particularly where they entail difficult institutional changes. There is also a risk of reform fatigue setting in before key changes are made. Supply side labour market measures could have been given more impetus at an earlier stage - especially the early activation and re-skilling of the long-term unemployed. The inclusion of health sector reforms, including pharmaceutical expenditure, in the original MoU could have secured more concrete results by 2013.

The implementation of structural reforms has been less consistent than other parts of the programme, probably reflecting a mix of technical, legislative and political challenges, their relatively low perceived priority, and their potential impact on vested interests. Both the Irish authorities and the three institutions may have paid insufficient attention to legislative constraints and possible needs for technical assistance and additional resources. Much-needed active labour market policies have taken time to become fully operational and reforms to the training sector have been implemented with delays. Initial progress in reforms to increase competition in the legal services was followed by excessive legislative delays. Reforms to the water sector have gradually progressed, but at the end of the programme the model and level of water charging was still under discussion. Towards the end of the programme the programme leverage also weakened, partly once it was clear it would be an overall success. The Troika could perhaps have been firmer in insisting on the timely implementation of meaningful reforms. The Irish authorities recognised that structural reforms were not the primary focus of the IMF and ECB.

What has been learned: Structural reforms needed to rebalance the economy should be included in the programme from the beginning. They then need to be worked up and resourced as soon as possible, given that their design and implementation takes time. Structural reforms can present significant technical and legislative challenges, and affect vested interests. Including necessary reforms in the programme increases the chances of them happening, but the sustained focus of the national authorities and the three institutions is needed to deliver timely and successful implementation. The possible need for technical assistance should be considered as part of the programme design process, or in early reviews. When structural reforms are complex and may be facing delays, the possibility of carving out priority aspects for early implementation should be considered.

External factors also played an important role in the success of the programme. Progress made at the EU/EA level in terms of governance and the banking union, as well as the steps taken by the ECB (for example President Draghi's July 2012 statement, OMT), helped engineer a rapid reduction in sovereign yields. The improvement in the EFSF/EFSM loan terms also contributed to Ireland regaining access to financial markets. Changes in the loans terms could have been accompanied by a discussion on whether or not to adjust fiscal targets in response. A reduction in the amount disbursed could also have been envisaged. The terms of loans provided by different creditors have an impact on the country's repayment choices and should be carefully considered.

Appropriateness of the size of financial assistance

One of the objectives of the programme was to ensure a smooth return to full market financing by covering Ireland's financing gap. The size of the financial envelope was determined on the basis of what was needed to provide a credible signal to markets that the sovereign's continued funding was ensured. The inclusion of sizeable contingent reserves for potential bank recapitalisations was warranted by the high volatility in financial markets and the uncertainty about the assumed capital shortfalls of Irish banks. The financing gap was fully covered in the early part of the programme, and Ireland had regained full market access before it ended.

The disbursement of tranches of financial assistance was made following an agreed schedule, after successful reviews of compliance with programme conditionality by the three institutions.

Despite lower than expected financing needs, Ireland received the full programme financial envelope. This allowed the Treasury to replenish the Treasury cash buffer. An alternative option might have been to reduce or even stop disbursements before the end of the programme. Even though it would have been legally feasible to reduce programme funding, the political and economic aspects of a potential stop to the disbursement of programme funds are anything but clear cut. In particular, reducing or even stopping disbursements might have undermined Ireland's successful return to financial markets. At the same time, the sizeable cash buffer that Ireland had built up at programme exit was a major factor behind the decision of the Irish authorities not to request a precautionary programme. It even paved the way for Ireland to repay the IMF loan well before maturity. Banking sector needs are extremely difficult to estimate at the outset of the programme, and proved to be lower than the programme envelope provided for. Ring-fencing the official funds assigned to potential bank recapitalisation needs would probably have limited disbursements or at least led to a more prominent discussion of the possibility of stopping disbursements.

What has been learned: In the presence of high financial market volatility and uncertainties about banks' capital needs, the inclusion of sizeable contingent reserves in the financial envelope adds to the credibility and effectiveness of the programme. Nevertheless, a faster-than-expected and apparently sustainable improvement in financial and economic conditions during the programme justifies a reassessment of the financing gap and the size of the associated disbursements. Ring-fencing the financial sector support in the total envelope would also be desirable, at a minimum to trigger an explicit reassessment of whether the full financial envelope needs to be disbursed.

Effectiveness in achieving programme objectives

The EU/IMF programme helped Ireland to achieve strong progress on three main objectives of the programme: (1) restoring the viability of the financial system, (2) consolidating public finances and governance to underpin fiscal sustainability and (3) ensuring a return to sustainable growth.

Concerning the financial system, the programme was effective in restoring creditors' confidence, as confirmed by access to debt markets by the two pillar banks. The pillar banks have recently returned to profitability. However, a significant portion of the banking sector still relies on the capital injected by the State. Banking supervision has significantly improved. Significant progress has been made in terms of downsizing the banking sector and addressing funding vulnerabilities, as indicated by the significant reduction in reliance on the Eurosystem and the improvement of the loan-to-deposit ratio. The banks' capital structure has also been significantly improved, although the ECB 2014 comprehensive assessment has confirmed some vulnerability. At the end of the programme, a decline in NPLs was yet to be seen, and this represented a continuing burden on banks' profitability.

Ireland met the fiscal targets in the programme with a margin. This was aided by the fact that the fiscal targets were not over-ambitious, but set in a realistic manner. This overachievement helped to foster a virtuous circle of good news and credibility for the programme. Based on latest forecasts, Ireland is on track to meet the EDP deadline. The changes made on both the revenue and spending sides have made the public finances more sustainable. Reforms to the tax system broadened the tax base and should reduce its volatility. Excessive social expenditure and the public wage bill were reduced, producing a sustainable spending reduction.

What has been learned: Consolidation plans which are realistic and in line with a country's priorities can give strong impetus and confidence to the consolidation process. Achievable fiscal targets give the programme stability and credibility.

The fiscal governance measures taken over the programme years should in principle be key to tempering pro-cyclical policy choices during good economic times, and to ensuring that debt is quickly reduced in coming years. While fiscal sustainability risks have eased over the years of the programme, in part due to the decision to reduce the margins payable on the interest, Ireland will need to pursue counter-cyclical fiscal policy in good times. The programme contained a number of key reforms to enhance fiscal credibility and anchor long-term debt sustainability. The fiscal framework's institutional strength will need to prove its worth in practice when economic expansion starts to produce revenue windfalls and calls for additional spending.

The overall macroeconomic picture is one of strong progress towards the resumption of sustainable growth. Real GDP and GNP have returned to robust growth. The current account balance is strongly positive. Developments in labour costs and the REER point to improvements in productivity and cost-competitiveness. Inflation remains subdued. Domestic demand is also showing signs of renewed growth, driven by both private consumption and investments. Broad-based reforms to tackle Ireland's labour market and skills problems have been put in place, though their implementation could have been quicker. Employment is growing and unemployment is decreasing.

The burden of adjustment was quite widely shared across Irish society. Ireland's social safety net continued to function effectively, though deprivation has risen. The economic crisis caused significant hardship in Irish society in the context of a sharp rise in unemployment, but the MoU avoided sharp across-the-board reductions in social support. As a result, the comprehensive social safety net that Ireland had in place prior to the programme remained intact. It was successful in mitigating increases in relative poverty, although indicators of enforced deprivation have risen. Nevertheless, the distributional impact of austerity measures was only periodically addressed in the programme reviews. Only in the last programme review was fair burden sharing stated as important for the sustainability of the adjustment strategy.

What has been learned: While it is known that economic crises and the subsequent adjustment can have high social costs, the distributional and social implications are generally difficult to estimate accurately at the start of a programme. However, distributional issues should be clearly and systematically addressed as part of the programme process and documentation.

Challenges

Challenges remain in addressing the legacies from the crisis. In particular, high private and public indebtedness and a large stock of NPLs continue to weigh on domestic demand and growth. Businesses and households remain focused on debt reduction which limits credit demand and is expected to subdue private consumption and investment. Banks continue to repair their balance-sheets by unwinding the large stock of NPLs and this also has an influence on credit supply.

The Irish economy depends on its capacity to attract FDI. It remains vulnerable to changes in the global patterns of product specialisation and shift in the structure of value chains and to losses in competitiveness. In addition, the predominance of foreign-owned MNCs in Irish external trade suggests extra caution in assessing the evolution of net exports and their impact on domestic economy.

Long-term unemployment and youth joblessness remain serious challenges. The rebalancing of the economy lowered demand for low-skilled workers and exacerbated skill mismatches. There remains a risk that some cyclical unemployment becomes structural.

Over the medium-term, the real test of the quality of the fiscal adjustment and the ability to bring the debt down from its current level will come when good times return. A prudent fiscal stance over the coming years will be vital to safeguard fiscal sustainability. The challenge will be to ensure that any

increases in spending are carefully considered and financed out of permanent revenue measures rather than windfalls.

Continued progress on the structural reforms undertaken as part of the programme should allow future growth to be more sustainable and inclusive, though possible post-programme reform fatigue has the potential to jeopardise further progress. The relatively slow pace of reform in regulated sectors to date has arguably had a negative impact on the fairness of the adjustment. A more cost-effective health sector is needed to accommodate the fiscal impact of an ageing society.

Ownership

The involvement of the Irish authorities in the preparation of the programme was substantive and ensured their ownership of the reforms in the programme. The fiscal and structural reforms also set out in the MoU drew heavily on the Irish NRP, which was itself finalised when discussions with the three institutions on economic adjustment were already underway.

The approach of largely aligning programme conditionality with the Irish authorities' NRP and keeping the MoU – and enforcement – light did support Irish commitment to delivering the measures in the programme. However, it contributed to the Troika's limited capacity to tackle delays or dilutions to reforms. This strategy posed a particular risk in the delivery of complex reforms to address long-term problems, especially when they could affect vested interests.

What has been learned: Ownership by the authorities is key to programme success. A programme consistent with national preferences fosters ownership. Nevertheless, with due consideration to the degree of ownership and institutional capability of national authorities, programme commitments concerning complex reforms to address long-term problems should be more detailed, and closely monitored, especially when vested interests are strong.

EU added value and coherence with other EU policies

Anchoring the action of the Irish authorities to a set of measures agreed with, and regularly monitored by, the European Commission and the other two partner institutions added to the credibility of the adjustment. This credibility allowed the adjustment to be implemented flexibility when needed. Credibility was mainly based on the content of the programme (including the size of financial assistance) and the strong ownership of the Irish authorities. The involvement of the European Commission and IMF and ECB added expertise and a European/international perspective to the programme design. During programme implementation, monitoring by the Troika reduced information asymmetries and allowed the necessary changes to conditionality not to be perceived as a sign of wavering commitment by the Member State.

The involvement of the EU was necessary to deliver an adequate financing envelope. The programme could not have been done by Ireland on its own, or the IMF alone. The size of the financial assistance reassured the markets, prevented a full collapse of the Irish banking system, and allowed the fiscal adjustment to be gradual. In addition, the use of financial resources at EU/EA level (EFSM/EFSF), rather than relying only on bilateral loans, allowed Ireland to benefit from very low costs once the interest rate margins were removed.

Enhancing the terms (maturity and interest rates) of the EFSF/EFSM loans contributed to debt sustainability and market access. The decision to lower interest margins on EFSM/EFSF loans also resulted in a sizeable windfall gain for the Irish Exchequer and made compliance with the public deficit targets easier. The resulting differences between the terms of the EFSF/EFSM and IMF loans make the ESM (as the successor to the EFSF) a much more attractive lender than the IMF for any future programme. As a result of the higher charges payable on its IMF loans, Ireland proceeded with an early

repayment of IMF loans in October 2014, after obtaining the waiver of the requirement for simultaneous proportional early repayments of the EFSF and EFSM loans.

The programme was consistent with EU rules and the Irish experience helped inform the design and clarification of new EU/EA frameworks. Wider EU initiatives contributed significantly to the programme's success. At the time when the Irish programme was put together, the so-called "Six Pack" of legislation was being negotiated at EU level. This contained the Directive on national budgetary frameworks. In May 2013, the Directive was supplemented by the "Two Pack". This mandated a role for independent bodies in the preparation of EA countries' budgets and in the monitoring of their fiscal rules.

The programme targets were aligned with the Stability and Growth Pact. In order to achieve this, the EDP was adjusted to reflect the evolution of macroeconomic conditions, by extending the deadline for achieving the 3% deficit by one year to 2015. This was an important step in ensuring consistency.

The programme monitoring and implementation process had beneficial spillover effects on the Irish public administration. The Irish authorities created a special unit attached to the Treasury which was tasked with coordinating the quarterly programme review process and ensuring the timely and effective implementation of reforms. This was testimony to Ireland's administrative competence and ownership of the programme. It helped to give a cross-government focus and ensured consistency. The Irish authorities improved evaluation of their policies. Insofar as this approach has become embedded, it can increase the effectiveness of the Irish public administration.

What has been learned: The creation of a structured process for monitoring and enforcing programme reforms within the national administration is beneficial to a programme's success. It can have positive spillover effects on the efficiency and effectiveness of a national public administration.

ANNEX 1

Method/Process

This ex post evaluation has been designed to comply with both the Commission's evaluation standards and international best practice. This annex describes the main procedural and methodological aspects of the evaluation introduced to ensure compliance with these principles. First, it describes the institutional arrangements to ensure the independence and impartiality of the evaluation exercise. Then it sets out the procedure that was followed in undertaking the evaluation.

The Director General of the European Commission's Directorate General of Economic and Financial Affairs' (DG ECFIN) appointed a Steering Group to oversee the evaluation and guarantee its independence. It was composed of senior officials from DG ECFIN, and officials from DG Competition and DG Health. The Steering Group provided guidance, ensured impartial supervision during the overall process and assessed the quality and usefulness of the final outcome of the evaluation. The evaluation was carried out by staff of Unit A.2 'Programme Design and Support' of DG ECFIN, which was not the operational Unit DG ECFIN in charge of the Irish programme. After revision by the Steering Group, the evaluation mandate was approved by the Director General of DG ECFIN on 30 September 2014. An inception report was submitted to the Steering Group who discussed and approved it on the 6th of October. On the 17th of December, after the finalisation of data collection, the Steering Group discussed and approved the Interim report. The final report was presented to the Steering Group on the 22th of May 2015. It has not been subject to approval by the hierarchical line. Following a copy being transmitted to the Irish authorities on the 27th of May 2015, the Irish authorities were invited to transmit their comments to the Commission. In addition, they provided their general views on the evaluation, which are published in annex 2. In general, it has to be acknowledged that during the overall process, inputs have been provided by many actors, including the Steering Group, the Irish authorities, academics and experts (workshop – see later) and this open exchange has been fruitful and helpful.

The evaluation mandate set out the following question for the evaluation to answer:

Was conditionality (programme design) appropriate in relation to the outputs to be produced and the objectives to be achieved?

To what extent have the objectives of the economic adjustment programme been achieved?

Was the disbursement of the financial assistance appropriate?

What was the rationale for an intervention at EU level? (EU added-value of the intervention).

Were the measures of the economic adjustment programme coherent with previous assessments made under the COM surveillance process and in line with the relevant EU policies (including '*acquis communautaire*')?

In addition to analytical work based on data and published documents, the evaluation team collected evidence from individuals and bodies involved in the Irish programme. The inputs into the analytical work included publically available data, Commission, ECB and IMF reports, documents published by the Irish authorities and other international organisations as well as private sector and academic research. European Commission staff who were involved in the Irish programme participated in interviews and meeting with the evaluation team.⁽²⁵²⁾ Representatives of EU Member States were consulted in their capacity as members of the Economic and Financial Committee (EFC).⁽²⁵³⁾ A number

⁽²⁵²⁾ This included officials working on the Irish country desk (Unit ECFIN.E.2) or in relevant horizontal units – both during the evaluation and previously – and officials working in other DGs who have been involved in the design and implementation of the programme.

⁽²⁵³⁾ The EFC is a committee of the EU, involved in preparatory work for the Council of the EU. It is composed of senior officials from national administrations and central banks, the ECB and the Commission. A questionnaire was sent to its members on the 29th of October 2014 with a deadline the 14th of November). 14 Member States sent a written reply.

of Irish stakeholders were consulted through written questionnaires. ⁽²⁵⁴⁾ Meetings to collect information and assessments on a number of issues took place in Dublin with relevant Irish authorities/agencies. The evaluator contacted the External Programmes Compliance Unit (EPCU) at the Department of Finance and sent the list of issues to be addressed during these meetings in advance. On the basis of this list, EPCU provided assistance in identifying the relevant authorities/agencies and the appropriate interlocutors. ⁽²⁵⁵⁾ Meetings with relevant representatives of the ECB and the IMF also took place.

To answer the evaluation questions, the evaluator followed the lines of enquiry listed below:

The appropriateness of the overall programme design and outcomes: the focus ⁽²⁵⁶⁾, pace and timing, flexibility of conditionality ⁽²⁵⁷⁾ and whether the burden of adjustment has been shared fairly across Irish society were assessed. The assessment consisted of a qualitative analysis, supplemented by an examination of relevant economic and financial data.

Extent of achievement of the objectives of the economic adjustment programme: the evaluation identified and examined relevant economic/financial data and complemented this with a qualitative analysis.

The appropriateness of the disbursement of financial assistance: the evaluation method identified the main differences between Ireland's actual financing requirements and those foreseen at the inception of the economic adjustment programme and an analysis of the evolution of the Irish sovereign's access to market during the programme period.

The level of ownership and administrative capacity of the Irish authorities and cooperation among the three institutions involved in the programme (European Commission, ECB and IMF). ⁽²⁵⁸⁾

The rationale for an intervention at EU level: qualitative analysis focused on identifying the added-value of an EU-level intervention, in terms of EU-led policy dialogue and monitoring and the collection of financial resources at EU/EA level rather than only relying on bilateral loans or IMF financial assistance.

The coherence of the main measures of the economic adjustment programme with other EU policies (including '*acquis communautaire*')? ⁽²⁵⁹⁾.

⁽²⁵⁴⁾ These Irish stakeholders were: Irish Banking Federation, Irish League of Credit Unions, Credit Union Development Association, Irish Business & Employers Confederation, Irish Small and Medium Enterprises Association, Construction Industry Federation, Irish Congress of Trade Unions, Society of St Vincent de Paul, Social Justice Ireland, Irish National Organization for the Unemployed, European Anti-Poverty Network, Irish Association of Pension Funds, Economic and Social Research Institute. The written questionnaires were sent between the 27th and the 29th of October 2014 following direct contacts in order to ensure immediate consideration and maximise the rate of response. The initial deadline was the 14th of November 2014; the last contribution was received on the 27th of November 2014. In the end, 9 of the above mentioned stakeholders participated to the consultation.

⁽²⁵⁵⁾ These authorities/agencies were: Central Bank of Ireland, Department of Finance, Department of Public Expenditure and Reforms, National Treasury Management Agency, Department of Jobs, Enterprise and Innovation, Department of Social Protection, Department of Health, Department of Justice and Equality, Department of Environment, Community and Local Government, Fiscal Advisory Council, Competition and Consumer Authority.

⁽²⁵⁶⁾ This entailed evaluating whether: Measures of the adjustment programme were relevant in relation to the economic challenges faced by Ireland and whether they proved to be well designed (design); Measures had the intended or unexpected consequences (outcomes); Significant relevant measures were missing from the programme (design).

⁽²⁵⁷⁾ In relation to unexpected developments (exogenous factors) and/or results falling short of goals.

⁽²⁵⁸⁾ Qualitative analysis focused on: a. Level of ownership of the programme by the Irish authorities, including the identification of success factors and areas for improvement; b. Administrative capacity of the Irish authorities to implement the programme; c. Possible divergences of stance between the three Troika institutions on major issues pertaining to the programme and how reconciliation was achieved; d. whether there were ECOFIN decisions that had a marked influence on programme design or implementation.

⁽²⁵⁹⁾ Qualitative analysis focused on assessing whether the main measures of the economic adjustment programme were coherent with previous assessments made under the COM surveillance processes (including the Excessive Deficit Procedure) and whether they were in line with the relevant EU policies (including '*acquis communautaire*' - this analysis focused on the main policy fields where co-operation with other DGs has been pursued within the programme framework. It was based on interviews with the officials of other DGs who were involved in the programme context).

The preliminary findings of the ex post evaluation were discussed during a workshop with academics and experts. The workshop was organised by the evaluator under the guidance of the Steering Group. The final outcome of the evaluation benefited from the resulting open exchange of views.

The evaluation is primarily qualitative, in the sense that it is based on economic judgement, rather than on an econometric analysis of data. The alternative of using a macro economic model is not appropriate in the context of an ex post evaluation of such a multi-faceted programme due to the exceptional nature of the crisis (especially in the euro area context of the time) and the importance of the political context and other unobservable and/or exogenous factors. For these reasons it would not have been practical to use DG ECFIN's QUEST model for this ex post evaluation. The approach taken allowed a much wider range of factors to be taken into account, which can deliver conclusions that are more relevant in terms of institutional learning.

The evaluation encountered some limitations, particularly with respect to the non-availability of some individuals involved in programme design/implementation and the relatively short time since the end of the programme. This hampers the ability to draw strong conclusions on the sustainability of some programme's achievements. The programme dates back to 2010; in some cases officials who were directly involved in its design or in the early stages of its implementation are no longer working for DG ECFIN. This is also the case for staff of the other institutions and for Irish officials. Whenever possible these officials were called to participate in meetings, despite having moved to other assignments. The evaluation found out that, for the main issues, their replacements were generally able to provide the necessary information and assessments.

To the extent possible, the evaluation is placed back in the context that existed at the time of the programme, in Ireland and in the euro area in general. This is facilitated when factual data are available. During the course of the evaluation, it became clear that there was sometimes a reasonable degree of disagreement between the various stakeholders on some elements of this context. This can affect their assessment of actions taken and can make it difficult to reach clear cut conclusions. In these cases, data and/or arguments in favour and against the appropriateness of certain measures have been presented. This is for example the case for the bail-in of unguaranteed and unsecured senior bondholders. The decision at the time was driven by a consideration of alternative risk scenarios of the likely impact of the bail-in option. The assessment about the appropriateness of avoiding this bail-in relies heavily on the arguments brought forward at that time and on what people can recall of the exact context and the events sequencing that led to the decision. For this reason, consultation on this issue has been particularly extensive.

The fact that this ex post evaluation is taking place one year after the end of the programme represents a limitation for making a definitive assessment about the medium-long term objective of return to sustainable growth. A number of structural reforms that are crucial on a medium-long term perspective and that started under the programme have not yet been finalised, making it difficult to reach concrete conclusions on their longer term impacts.

ANNEX 2

The Irish Authorities' Views on the Ex Post Evaluation

The Irish Authorities broadly agree with the main findings of the Ex-Post Evaluation (EPE) report. We note that its aim is to assist the European Commission in drawing lessons from the programme as a whole to inform the policy debate and improve future policy-making. We welcome the EU's recognition that Ireland's smooth return to the markets and the resumption of strong economic growth in 2014 are evidence of the overall success of the Irish programme. We also welcome the comment that the Irish Authorities' ownership of our programme was a key factor in the ability to deliver on the programme objectives. We would therefore like to comment on a number of issues related to our programme, and the commentary on these which is included in the report.

Ireland's Programme - overview

Ireland's programme had four broad and interrelated aims - to address financial sector weaknesses, to raise Ireland's growth potential, to strengthen our public finances, and to fully regain international capital market access. The programme provided Ireland with stable funding at reasonable rates (once margins were removed), and enabled Ireland to implement its very significant adjustment process in an appropriate manner and within a reasonable timeline. The programme design broadly reflected the assessment of the Irish authorities of the measures which would be required to meet the fiscal adjustment and structural reforms required as set out in the National Recovery Plan published which was prepared by the Department of Finance before Ireland applied to the EU/IMF for financial assistance. Similarly, the financial sector measures reflected recommendations in the report of the Central Bank Governor – also in 2010⁽²⁶⁰⁾.

The programme is widely recognised as being a success, with programme commitments delivered within the agreed deadlines. The financial sector has been significantly restructured with considerably enhanced supervision, substantial re-capitalisation and frequent external reviews. Order has been restored to the public finances, spending is under control, the revenue base has been broadened and revenues are rising all of which are leading to the achievement of an expected primary surplus in 2015. Public debt was stabilised and is now firmly on a downward trajectory and Ireland is on target to correct its excessive deficit with a general government deficit below the Excessive Deficit Procedure (EDP) ceiling in 2015 as required. The economy is growing strongly again – by around 4% this year and is forecast to grow by close to 3.8% in 2016. Employment is also increasing strongly and unemployment has fallen to below 10% from a peak of 15.1% in 2012. All of this has been achieved by steadfast implementation and delivery of our commitments under the programme and complemented by European decisions that led to a reduction of the interest rates on the EU facilities and bilateral loans and an extension of the maturities of the EFSF and EFSM loans.

This strong implementation record culminated in a successful exit from the programme on schedule at the end of 2013, without the need for a precautionary backstop.

Pace and speed of consolidation: Ireland met and frequently outperformed its programme fiscal targets, both the annual underlying deficit ceilings under the EU's EDP recommendation, and the quarterly Quantitative Performance Criteria set out in the IMF's Technical Memorandum of Understanding. This was achieved despite the fact that at the time growth both domestically and internationally was lower than that projected both by the Irish authorities, and by the external partners, when the programme was being agreed.

In particular, economic growth in Ireland disappointed in 2011 and 2012 compared to programme expectations, particularly domestic demand, employment and unemployment. This was due in part to the weaker-than-anticipated growth in the global economy, but also the private debt overhang at domestic

⁽²⁶⁰⁾ Report Title: The Irish Banking Crisis Regulatory and Financial Stability Policy 2003-2008. A Report to the Minister for Finance by the Governor of the Central Bank 31 May 2010

level. This weaker-than-expected growth meant that suggestions about tightening of fiscal targets in response to lowered interest rates (as suggested in the Report) would have been inappropriate and almost certainly counter-productive in terms of being excessively pro-cyclical.

In this context, it is important to emphasise that the reduction in the interest rates for the EU sourced loans, and the extension of the maturities on the EFSM and EFSF loans were undertaken to support debt sustainability and were evidently successful in that aim. The reduction of interest rates was appropriate as the initial high rates were motivated in part by “moral hazard” concerns relating to programmes – concerns which it is now clear are addressed by the policy conditionality which accompanies programmes and the political cost associated with being in a programme.

The assessment of policy choices should have regard to the options available to Ireland at the time. The report includes a lengthy discussion of the potential bail-in of senior bondholders. However, at the time of the banking crisis the option now included in EU law as part of the Banking Union at a European level - bailing-in of senior bondholders - was not available to the Irish Authorities despite the previous Government seeking this option for banks in wind down. The firm view at the time from the three institutions, was that sovereign support for banks was necessary to avoid contagion. This meant that the burden had to be borne by the equity holders, the junior bondholders, and particularly by the Sovereign which ultimately meant the Irish taxpayer. This approach has been highly controversial and is an issue which has yet to be fully resolved. The report’s references in this area must be viewed in terms of lessons learned for future EU programmes.

It is important to prioritise legislative commitments. Ireland’s programme was characterized by a very heavy legislative burden reflecting principally the need for significant reforms in relation to financial sector regulation. Ireland is acknowledged as having a well-functioning administration, and the capacity limits to the amount of legislation that could be undertaken successfully are recognised in the report. These capacity limits arose at administrative level, for technical drafting skills and also for Oireachtas (Parliament) time. It is important to recognise that such capacity limits are not readily addressed by short term expansion of resources as suggested. Furthermore capacity issues also arise in the wider society in terms of the ability to implement and successfully deliver difficult change with evident winners and losers. It is therefore essential that programme conditionality is appropriately prioritized and phased so as not to undermine the overall policy goals. Overloading any administrative and legislative system will damage programme effectiveness. While this did not, fortunately, occur in Ireland’s case the programme legislative requirements nevertheless placed a significant burden on the system as a whole.

In this context, it is important to recognise that in Ireland’s case the Government cannot, constitutionally, pre-commit the Oireachtas to pass legislation and the approach of committing to the introduction of legislation was therefore the appropriate format for Ireland and one that recognises Ireland’s domestic legislative process.

It is important that programme conditionality should prioritise the policy areas in most urgent need of attention. Ireland’s programme placed a strong emphasis on Financial Sector restructuring and restoring order to the public finances – as these were the areas demanding most urgent attention. The structural reform element of the programme was important in improving the growth prospects of the economy, but was recognised by all concerned as not being the primary focus of our programme reflecting the highly flexible nature of Ireland’s economy. Commentary about greater frontloading of structural reforms should therefore have regard to this fact, and to the previous observations concerning capacity, prioritisation and phasing of programme conditionality.

It is nevertheless important to recall that significant structural reform was introduced during the programme including; changes to the personal insolvency framework, labour market activation policies, Further Education and Training (FET) programmes, reduction in pharmaceutical expenditure, reform of public sector wages and pensions, reform of sectoral wage agreements, health sector reforms, reform of

the water sector and improvement in the competition law framework. Furthermore, it should be noted that all these difficult measures were delivered without social unrest – an important point often overlooked by those that assess programme success in terms of the quantity of programme commitments.

The programme should be flexible and reflect each State's individual market conditions and cultural sensitivities. EU-IMF programmes are complex and involve the co-operation and agreement of many stakeholders. A degree of flexibility is required to ensure its policies are able to adjust to the multi-institutional complex circumstances faced during a program. Although core objectives such as growth and debt sustainability are central, each country is unique and a one size fits all approach should not be utilised in program design. Individual market and cultural sensitivities should be recognised.

Programme Funding: At the outset of the programme, a financial envelope of €85 billion was identified as being appropriate, with €67.5 billion of this being provided externally from EU and IMF sources, and €17.5 billion being provided by Irish Government sources.

It was appropriate that the overall programme funding envelope was drawn down – as this contributed to the development of a strong cash buffer – which in turn supported a successful exit from the programme and a durable return to market funding. In this context, suggestions about ring fencing or re-assessing planned disbursements during a well performing programme should be viewed with caution. Such an approach could potentially undermine the success of a well performing programme and have unintended negative consequences on the achievement of targets.

Additional lessons learned include the importance of political and social cohesion and effective communications management. A notable feature of Ireland's programme is that social cohesion was broadly maintained – notwithstanding the significant fiscal adjustment which was already well underway before the programme started and had resulted in a substantial reduction in in pre-crisis living standards. Suggestions about more consolidation and reforms must be viewed in that context given that it was essential for social cohesion that Ireland's social safety net worked to protect the most vulnerable and that key public services continued to be provided effectively. As outlined in SILC 2014, Ireland's system of social transfers, the redistribution of wealth and income to those most in need, is among the most effective in Europe at reducing the at risk of poverty rate. Both the programme period and the period before the programme saw significant reductions to the public service pay bill and to the numbers employed in the public service. Against this background, the agreements negotiated with the employee representatives of public servants secured industrial peace in the public service, made a very significant contribution to the fiscal consolidation effort required to meet programme requirements and provided that productivity in the use of resources be greatly increased through revised work practices, redeployment and other initiatives in order to meet the increased demand on public services.

Communication to the various audiences is also very important. Clear, and consistent messaging can support the restoration of confidence when supported by steadfast programme implementation.

Conclusion

We would like to thank the Commission staff for their considerable efforts and constructive support during the negotiation and implementation of the programme and for the policy advice that we received.

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