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To: S. Deroose Via: I.P. Székely [redacted]

[redacted]

From: [redacted]

Subject: **Second Post-programme Surveillance (PPS) Review Mission, 17-21 November, 2014**

In the week of 17 November, Commission and ECB teams visited Dublin to undertake the second PPS mission. The mission was coordinated with the IMF's Post-Programme Monitoring (PPM) mission. The teams met with numerous public and private sector entities. The ESM also participated in the meetings on aspects related to its Early Warning System. The mission consisted of [redacted]

The mission confirmed the much improved macro-financial environment and outlook. At the same time, it also corroborated signs of adjustment fatigue against the backdrop of an increasingly challenging political landscape as the popular support for the current government is fading. As a result, while the adjustment process undertaken under the EU-IMF financial assistance programme continues, its pace is slowing somewhat especially in public finances and some structural reforms. Financial reforms and the restructuring of the domestic banks continue to advance in reaction to the outcome of the ECB's Comprehensive Assessment (CA). The unsurprising results revealed a capital shortfall for PTSB, which the bank is expected to confront comfortably. A new state-backed company to boost SME lending may give rise to some new contingent liabilities.

The economic recovery is solid though some uncertainty remains concerning its underlying strength. In 2014, annual GDP growth could even exceed the latest Commission forecast of 4.6%. However, this figure may overestimates the underlying buoyancy of the economy, as net exports have been boosted partly by contracted production, which has no genuine impact on the Irish economy and may be a temporary factor[2]. Domestic demand is expected to have contributed 2.3 percentage points to real GDP growth in 2014. As for 2015, investment and private consumption should continue to recover from low levels and drive GDP growth. The EUR 1 billion expansionary

[redacted]

[2] Contracted production occurs when a resident entity in Ireland contracts production of goods abroad. The sale of the good is recorded as an export from Ireland (and inputs used during the production process are also recorded as imports to Ireland) irrespective of their not entering Irish soil.

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package in budget 2015 could add up to 0.3 percentage point to GDP growth. Conversely, the main uncertainties relate to the evolution of exports, which could be affected by changes in foreign contracting by resident multinationals and lower growth in the euro area. Thus, there is a particularly wide range in agents' annual 2015 growth forecasts from 3% to 5%.

Despite some unanticipated expenditure pressure in 2014, Ireland is expected to comply with the EDP recommendations in 2014 and next year. This is substantiated by their strong track record established over the programme years. Still, additional expenditure overruns were revealed during the mission (of EUR 500 million or 0.3% of GDP) in the health care sector compared to the 2015 Draft Budgetary Plan (DBP). Unlike previous years, these will not be offset by savings in other areas. There will also be a frontloaded capital transfer to Irish Water of EUR 277 million (0.15% of GDP) in 2014 following the decision to delay the introduction of the charge system to next year announced on 20 November (Box 1). This means the 2014 general government deficit is likely to be above 4.0% of GDP, above the 3.7% of GDP Commission autumn forecast, but still below the 2014 EDP ceiling of 5.1% of GDP. Some extra revenues are expected in late 2014 due to higher-than-projected growth but these will only partially compensate for the overruns. For 2015, despite tax cuts and increases in certain expenditures, the government affirmed it will reduce the deficit below the 3%-of-GDP reference value to exit the EDP. However, the margin is narrowing and medium-term risks emanate from possible spending overruns due to demographic changes, public service pay and pensions, climate change, education and the potential reclassification of Irish Water to the general government We believe that the 2015 budget deficit at 2.9% of GDP projected in the 2014 autumn forecast is still valid. There is also a need for a more effective medium term budgetary planning and a more binding framework to set expenditure ceilings.

Financial reforms remain on track with focus on the outcome of the CA, arrears resolution and SME financing.

- As broadly expected, of the three main domestic banks, only PTSB did not meet the capital requirement under the CA's adverse scenario. It has submitted a capital plan to the ECB to address the EUR 855 million capital shortfall. The plan will be reviewed by the SSM Supervisory Board in December. There is some uncertainty as to whether EUR 400 million of contingent capital or "cocos" are eligible to meet the shortfall without conversion into equity. PTSB has mandated an external consultant to assist it in raising capital and has had extensive contacts with private investors. The bank's management is confident that any remaining gap not addressed via deleveraging and post-provision profits in 2014 can be filled by private capital. The authorities also indicated that a plan to restore Allied Irish Bank (AIB) to the private sector will be announced before Christmas.
- The third quarter 2014 mortgage arrears restructuring targets (MART) were met but about half of sustainable solutions continue to rely on legal action using the threat of repossession. Nevertheless, actual repossessions remain low but are increasing at an accelerated pace. There is anecdotal evidence that capacity constraints are beginning to emerge in the court system, reflecting the long duration of the process (with multiple adjournments). Commercial loan restructurings continue to progress though this remains a lengthy process. A pick up in the domestic property market has aided more portfolio sales.
- The state development corporation for SMEs, the Strategic Banking Corporation of Ireland (SBCI), is expected to begin providing loans via existing credit institutions towards the end of 2014. It will have about EUR 800 million (0.45% of GDP) in funds and some of the lending will involve state guarantees subject to 'de minimis' rules for state aid.

[redacted]

Structural reforms are making uneven progress. Reforms to further education and training are now advancing apace, even though it will take time before the new institutional setup and training programmes are entirely effective in addressing skills mismatches. The implementation of the *JobPath* programme should provide welcome additional activation support to the long-term unemployed starting in the second half of 2015. Key strands of reforms in healthcare are progressing, but further advances will be necessary to reap additional efficiency gains and better control health expenditure without compromising healthcare delivery. Enactment of the Legal Services Regulation Bill will not take place in 2014 as planned and the establishment of multidisciplinary practices faces increased uncertainty [redacted]

Press outputs. On the final day of the mission, the Commission Services and ECB released a joint press statement. The IMF published a separate concluding statement the same day. The main messages were aligned.

Next steps. A timeline of events (endorsed with the policy brief) leading to the conclusion of the second PPS review by the Commission (and consultation with the EFC) is presented in Annex 1. The review will be discussed at the EWG/EFC meetings on 15-16 January 2015. A version of the Commission services' report will be published as an ECFIN Occasional Paper towards late January. A dedicated discussion of the implementation of MIP-tagged CSRs under specific monitoring will take place in the EPC on 18-19 February 2015 following the EWG/EFC meetings.

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

Annex I: Timetable for second post-programme surveillance report

2014-10-14	PPS
Last updated =>	2014-09-04
Sat 22/11	
Sun 23/11	
Mon 24/11	
Tue 25/11	BTO to HoU.
Wed 26/11	
Thu 27/11	
Fri 28/11	
Sat 29/11	
Sun 30/11	
Mon 01/12	
Tue 02/12	
Wed 03/12	
Thu 04/12	
Fri 05/12	
Sat 06/12	
Sun 07/12	
Mon 08/12	
Tue 09/12	Draft PPS report to HoU.
Wed 10/12	
Thu 11/12	
Fri 12/12	Draft PPS report to Dir H.
Sat 13/12	
Sun 14/12	
Mon 15/12	
Tue 16/12	
Wed 17/12	Draft PPS report to Cabinet.
Thu 18/12	
Fri 19/12	
Sat 20/12	
Sun 21/12	
Mon 22/12	
Tue 23/12	
Wed 24/12	
Thu 25/12	
Fri 26/12	
Sat 27/12	
Sun 28/12	
Mon 29/12	

Tue 30/12	
Wed 31/12	
Thu 01/01	
Fri 02/01	
Sat 03/01	
Sun 04/01	
Mon 05/01	PPS report sent to authorities, IMF, ECB and ESM for comments.
Tue 06/01	
Wed 07/01	
Thu 08/01	Revisions introduced into PPS report
Fri 09/01	Submit PPS report to EFC (via EFC secretariat).
Sat 10/01	
Sun 11/01	
Mon 12/01	
Tue 13/01	
Wed 14/01	
Thu 15/01	EFC/EWG
Fri 16/01	EFC/EWG
Sat 17/01	
Sun 18/01	
Mon 19/01	
Tue 20/01	
Wed 21/01	
Thu 22/01	
Fri 23/01	
Sat 24/01	
Sun 25/01	
Mon 26/01	PPS staff report published.
Tue 27/01	
Wed 28/01	
Thu 29/01	
Fri 30/01	
Sat 31/01	
Sun 01/02	

Mon 02/02	
Tue 03/02	
Wed 04/02	
Thu 05/02	
Fri 06/02	
Sat 07/02	
Sun 08/02	
Mon 09/02	
Tue 10/02	
Wed 11/02	
Thu 12/02	
Fri 13/02	
Sat 14/02	
Sun 15/02	
Mon 16/02	
Tue 17/02	
Wed 18/02	EPC discussion of MIP-tagged CSRs.
Thu 19/02	EPC discussion of MIP-tagged CSRs.
Fri 20/02	
Sat 21/02	
Sun 22/02	