December 6, 1999
Approval: 12/13/99

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 98/106

10:00 a.m., October 14, 1998

Contents

Decisions Taken Since Previous Board Meeting

Executive Board Attendance

S. Sugisaki, Acting Chairman

Executive Directors	**Alternate Executive Directors**
	S.M. Al-Turki
	C.X. O'Loghlin
	W. Szczuka
	W.-D. Donecker
	J. Spraos
	T. Belay, Temporary
K.A. Hansen	
	O.L. Bernal, Temporary
	J. Prader
	B.S. Newman
J.-C. Milleron	
	M. Daïri
	I. Zakharchenkov, Temporary
S. Pickford	
	M.H. Elhage
	N. Jadhav, Temporary
	A.G. Yakub, Temporary
	J.L. Pascual, Temporary
J. de Beaufort Wijnholds	
	S. N'guiamba, Temporary
	D. Fujii, Temporary
	M.Z. Maatan, Temporary
	Wang X., Temporary
	J.A. Costa, Temporary

A. Linde, Acting Secretary
P. Kunzel, Assistant

Ireland—1998 Article IV Consultation
Staff representatives: H. Vittas, EU1; Kincaid, PDR

Also Present
European I Department: Y. Horiguchi, Deputy Director; V. Cerra, M.J. Fetherston, N.A. Koliadina, A. Leipold, S.H. Samiei, H. Vittas. Fiscal Affairs Department: L.P. Ebrill. Policy Development and Review Department: G.R. Kincaid. Secretary's Department: B.A. Sarr. Advisors to Executive Directors: B. Couillault. Assistants to Executive Directors: S.A. Bakhache, J.G. Borpujari, M. Budington, N.K. Gueorguiev, M.R. Hajian, C. Josz, C-P. Schollmeier, M. Walsh, P. Winje.

1. IRELAND—1998 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1998 Article IV consultation with Ireland (SM/98/234, 9/22/98). They also had before them a background paper on selected issues in Ireland (SM/98/238, 9/30/98).

Mr. O'Loghlin made the following statement:

My authorities have asked me to convey their appreciation to the staff for a perceptive and well-balanced report on developments in the Irish economy; for their thorough analysis of prospects both near- and longer-term; and for their most useful assessment of the threats to be addressed if the solid progress with which we have been blessed in recent years is to continue. They broadly agree with the assessment provided. The various concerns raised in the staff report, which are already at the heart of policy formulation, will continue to inform decision-making over the months and years ahead.

1997 proved to be yet another very positive year for the Irish economy. GNP rose by 7¾ percent. Growth was broadly based. Domestic demand rose by 7 percent, supporting employment gains of the order of 3½ percent. Joblessness declined further, falling below the EU average in the latter part of the year. Inflation remained low, with consumer prices rising by 1½ percent. While investment and consumer demand powered ahead with an associated expansion of imports, exports also rose strongly so that the surplus on the current account of the balance of payments remained close to 3 percent of GDP. Thus, despite substantial net repayments of foreign-currency-denominated and externally-held public debt, external reserves remained quite comfortable. There was encouragement, also, in terms of future prospects. Investment rose more strongly than other elements of domestic demand—reaching 20 percent of GDP—with outlays on productive infrastructure and business assets moving ahead just as rapidly as those on housing construction. And, with growth considerably stronger than anticipated, the general government balance moved into surplus.

Thus far, despite prevailing international uncertainties, 1998 is shaping up to repeat last year's performance. Export and retail sales volumes were well up through the early months. Buoyant indirect tax receipts also evidence strong growth in consumption, while receipts of personal taxes point to strong growth in aggregate earnings. Anecdotal evidence of continuing in-migration combined with a further decline of almost 1 percent in the unemployment rate (to 9 percent) by end-August, suggests that buoyant personal tax receipts reflect ongoing employment gains rather than an undue burgeoning of wage rates. While consumer price inflation did pick up through the year, the acceleration has tapered off in recent months. My authorities anticipate some unwinding in the period ahead, given recent trends in the effective exchange rate of the Irish pound. External reserves have increased very appreciably since end-1997. And latest budgetary data suggest that the fiscal surplus for the year will be well ahead of budget.

It has been agreed that Ireland will be one of the group of countries to launch the Euro project from January next. My authorities are committed to playing their part in ensuring the success of EMU. In this context, given the risks to inflation inherent in the buoyancy of the economy, they have sought to limit the monetary easing which EMU poses for Ireland by delaying the approach of Irish rates to the levels prevailing in core-EMU countries. Those efforts, however, have been more symbolic than real since policy can impact on short-term rates only. It seems clear from data on credit and on durables/housing expenditure that consumers have already anticipated core-country short-term rates in their decision-making, in light of the certainty since May that Irish rates would move down by end-year. My authorities are confident, therefore, that there will be no significant further impact on consumer sentiment as rates continue to align (our Central Bank reduced its key rate by 100 basis points at the weekend).

Directors will recall that, in the run-up to the May decision of the European Council, the Irish pound's central rate within the ERM was revalued by 3 percent. The staff report poses the question whether a larger revaluation might have been warranted then, to contain the risk of escalating inflation. While the issue is academic at this juncture, I would note that the size of the revaluation was decided with both inflation and competitiveness concerns in mind. The likely sustainability of the then constellation of international exchange rates—in particular the strength of sterling—was a key factor. Directors will be aware that Ireland's trade-weighted exchange rate has appreciated by about 6 percent since the revaluation, strengthening the prospect that the recent pickup of inflation will unwind in coming months.

My authorities share the concern that rapid credit expansion can impact on the soundness of credit institutions and, as noted in the staff report, have intensified prudential supervisory effort. Notwithstanding the staff assessment—which they share—that recent developments "do not seem ... to pose significant systemic risks to the financial system," my authorities remain vigilant in this regard.

Ireland is especially aware that membership of a single-currency regime—where monetary policy must respond to the needs of the area as a whole rather than the potentially divergent requirements of some of its parts—gives a heightened importance to pursuit of sound fiscal policy. Since the economy is at a more advanced stage of the cycle than much of Europe, policy has been geared to keeping the economy on a path of sustainable growth with price stability. I am happy to inform Directors that latest estimates suggest we are on track for a general government surplus of the order of 2 percent of GDP, essentially keeping unanticipated revenue growth through 1998 for benefit of the fiscal position.

Constraining inflation is also a key focus in the ongoing preparations for the forthcoming budget. In this context, the aim will be both to support the unwinding of the recent pickup through 1999, and to enhance the prospect for maintenance of low inflation into the medium term by underpinning a continuation into the new millennium of the wage moderation of recent years.

My authorities are also keenly aware of the risks to inflation and to an extension of the long-standing social partnership—whether by demonstration effect on private sector demands or by preempting the resources needed to support future wage moderation with appropriate further easement of personal taxation—of conceding claims for substantial increases from groups within the public service.

My authorities also welcome the focus within the staff report on fiscal challenges which aging of public service and of the general population may pose. While the latter—the more critical impact—will touch Ireland rather later than other countries, it is useful to be reminded that the earlier action is taken to address such issues, the easier it will be to accommodate the increased pressure on the public finances which ageing must bring in the longer term.

The staff has underscored that, despite some reduction in the context of considerable growth in total employment, both youth and long-term unemployment remain high. My authorities share the view that income tax cuts and other structural reforms should focus on strengthening incentives, particularly at the lower end of the labor market, to respond to this situation. They will, I am sure, also pay close attention to the staff recommendations in the area of minimum wages with the same end in view. Other actions, elaborated in the Employment Action Plan which my authorities prepared earlier this year in response to an EU initiative, are also in train to further enhance the flexibility of the labor market.

Steps to enhance economic efficiency are also in train or in gestation in other areas of the economy. Notably, these include measures to cool off the housing market lest rising house prices aggravate wage demands; liberalization of licencing in some sheltered sectors where that has impacted on prices by limiting competition; diluting the monopoly position of certain public entities; and seriously reviewing the economic merits of retaining public ownership of certain essentially commercial activities.

While acknowledging that Irish statistics are generally adequate for effective surveillance, the staff correctly points to the potential weakness inherent in the undesirably long lag with which data on certain wage developments emerge. Directors may wish to know that the laggard series is that for manufacturing earnings where, as the staff acknowledges, the moderate terms of the current social pact "have been holding up much better than in some sheltered sectors." Data relating to financial and construction sector earnings is more timely and, of course, developments in public sector remuneration are known as they occur so that, from a policy-making perspective, the lag on the manufacturing side is more a potential than an actual weakness. While my authorities are intent on reducing this lag, the current key priorities are to fully comply with the statistical requirements of EMU membership on the one hand and of the Fund's SDDS on the other.

Mr. Spraos made the following statement:

Confronted with the performance of the Irish economy in the last decade, I am running out of superlatives. Even the rise of the rate of inflation from 1.5 percent at the end of 1997 to something like 3 percent now, which looks worrisome, can be expected to be transitory because, as the Irish authorities claim and the staff accepts, it is due to the exogenous depreciation of the effective exchange rate. Of course, it will only be transitory if second round effects of depreciation are avoided. This can be more easily achieved now that the depreciation has been partially reversed.

Basically, I do not think there is much we can teach the Irish about short- and medium-term macroeconomic management. Of course, they have stumbled before and they will stumble again. The elixir of perpetual macroeconomic miracle has not been invented yet. But the authorities' macroeconomic antennae are sensitive, as Mr. O'Loghlin's statement makes clear, and if the authorities stumble, it will be in spite of doing things which look broadly right ex ante. I will therefore select for discussion issues of wider resonance or of the long term. I will also raise a point which to me is a puzzle.

I have a worry about the long term that can be approached by posing the question: what is Ireland's comparative advantage that attracts Europe-oriented FDI? With just a little exaggeration, FDI can be said to be the life blood of the Irish success. What keeps it flowing at such a high rate? The English language helps, as does the high quality labor force, the latter operating in a climate of industrial peace thanks to the long-standing social contract. I will return to the social contract. But an important factor is also the relatively very low rate of corporation tax. My worry relates to this point. In the long term, can the low rate continue? Ireland has recently had discussions with the European Union about its corporation tax regime. What has come out will not be questioned for some years. But, capital being highly mobile, there will be pressures inside the EU for convergence of tax rates on profits and of investment incentives in general. More widely, on a world scale, the talk of disarmament in FDI incentives is getting louder. At the global level, it is just talk for the time being and it will probably not come to pass for a long time but, within the EU, convergence of profit taxation will probably surface on the agenda at some point. Such convergence may seriously affect the Irish growth model. Are there any studies which could throw some light on that?

Industrial peace is, as I have already said, another factor in Ireland's attractiveness for FDI. It has been secured by a social contract, which is currently labeled "Partnership 2000" but which has been running, in a number of variations, for many years. It is subject to some strains—what isn't?—but basically it is going strong. I very much welcome the staff's recognition in bold letters that "the social partnership arrangements worked well in the past" and welcome, especially, their assessment that "it is important to ensure their continuation in the future" (Staff Report, para. 17).

There is, I believe, a general lesson to be drawn from this assessment: in considering a total policy mix, allowance should be made for the trade-off between social contract and fiscal or labor market conditions. It is not just that fiscal tightening or labor market reforms do not operate in a social vacuum; in the context of a social contract, they do not operate in an economy where the optimal levels of such measures can be assessed without regard to the erosion, if erosion there be, of the macroeconomic advantages emanating from the social contract. If this trade-off is not systematically incorporated, the analysis is liable to be incomplete.

At a time when members of the EMU have lost monetary policy from their armory of macroeconomic weapons, the importance to them of addressing inflation through a social contract is likely to increase. So the Irish should nurture theirs.

My next point is that Ireland provides the most prominent of a number of counter-examples to the conventional wisdom that you have to rein in an economy's growth to its perceived potential at an early stage because, otherwise, you will end up with a hard landing and over the entire cycle you will be worse off.

Let me look at some numbers. The 1996 Article IV report considered that by 1995 Ireland had more than exhausted its output gap. It's growth potential was estimated at 5 percent per year. Had the Irish economy been reined in to 5 percent growth in the last three years, it would have lost a cumulative output of more than 10 percent of its 1995 GDP. It is implausible to think that a hard landing could cost that much.

The lesson that I draw is that the Irish should continue testing the boundaries of output expansion. The staff projects an average growth rate of 4.9 percent a year for the year 2000 and beyond. There is no knowing what will happen that far ahead. But, as a signal, 4.9 percent may be pessimistic for an economy with an elastic labor supply. I am not suggesting that the Irish authorities should behave as if there were no limit to growth, and they should, of course, be vigilant, changing gear downwards if serious signs of overheating emerge. But pessimism about growth prospects will be self-fulfilling when policy is predicated on pessimistic assumptions about growth potential. And this they must guard against.

I welcome, by the way, the staff's skepticism about output gap calculations. We cannot dispense with such calculations, but we must be more conscious of the circumstances under which they are liable to give grossly misleading results.

Waves (probably small) from the current world turbulence may lap the Irish coast but, Ireland, together with other strong economies, can best contribute to limiting global adversity by maintaining a high growth rate.

Lastly the puzzle: in an economy which attracts a large volume of FDI, the capital account balance has a negative sign. There is, in other words, a bigger export of capital than import of capital. This is the other side of the coin from the current account surplus. But it is a puzzle nonetheless. Two-way flows are, of course, normal up to a point. But, in the circumstances of Ireland, the scale of this phenomenon is unusual. If there is an explanation for this puzzle, it may help us to glimpse how things might evolve in the long run when the foreign capital inflow ceases to expand or even contracts.

Mr. Wijnholds made the following statement:

This report was a pleasure to read, not only because of the Irish success story that it describes, but also because of the attractive format. The small graphs surrounded by text are a useful aid for the reader.

The Irish economy's performance over the past years has been nothing short of spectacular. One particular indicator of this success which appeals to me—also as an instructive example in positive debt dynamics—is the fall in the ratio of general government debt to GDP by 40 percent since 1993. Ireland's performance has little to do with luck, and the authorities deserve to be strongly commended for their policies which underscore the benefits of stability-oriented macroeconomic policies and the importance of attracting foreign direct investment.

While I agree with the thrust of the staff's analysis, I wonder if it does not need a little adjustment in view of the fact that the discussion with the authorities took place 4 months ago in which time a lot has happened. It seems to me that some of the policy dilemmas facing Ireland, which could be described as the strains of success, are somewhat less acute now. This certainly is the case as far as the exchange rate entry level is concerned.

As far as the macroeconomic picture is concerned, the staff makes two main points:

First, although some moderation is expected, the exceptionally good times will continue; GNP is expected to grow by over 6 percent in 1999. Second, inflationary pressures have finally emerged, driven both by demand-side boosts and anticipations—fiscal and monetary—and supply-side bottlenecks, especially in the labor market. Here I would point out that the output scenario is based on the latest WEO projections which are generally considered to be on the optimistic side. I wouldn't go as far as to take the alternative low-growth scenario as just as probable, but would like to emphasize the downside risks. With world trade slowing down and diminished growth prospects for the European mainland and the United Kingdom, Ireland would find it difficult to match the exports performance of the recent years. In addition, the sharp decline of the stock market prices, possibly accompanied by an increase in uncertainty may lead to a dampening wealth effect on domestic demand.

Second, as the staff notes, the rise in inflation in 1998 is mainly due to the earlier effective depreciation of the Irish pound. However, recently the sterling rate has come down, effectively reversing part of the earlier depreciation. This and the expected cooling off of domestic demand, mentioned above would tend to offset the effect of lowering the short-term interest rates in the wake of the EMU launch. Regarding the latter, it has been known with certainty since May, so consumers and businesses have already incorporated it in their decisions, as noted in Mr. O'Loghlin's informative statement. Furthermore, as the deadline of January 1 approaches, the differences between holding the rate steady till the end, or, alternatively, lowering the rate in a few subsequent steps tend to become more and more marginal. This point was recognized by the Irish Central Bank, as evidenced by the recent drop of its key rate by 100 basis points.

Having said all this, I still see a need for sounding a few warnings. Keeping inflation down, however, is predicated on a conservative fiscal position in 1999. If only a part of the downside risks materialize, fiscal revenues may take a hit. Therefore, it is important to ensure discipline in meeting government's spending targets. In the past, some overspending has been compensated by larger-than-expected revenues, but this cannot be assumed for the next year, given that the government is rightly targeting a surplus of 2 percent of GDP and given its plans for further personal tax cuts. As noted in the staff report, the surplus is needed to retain room for maneuver in demand management in the context of the EMU. I would encourage the authorities to resist pressure for large pay raises by various groups of public sector employees. This is a necessity both because of the direct impact on the budget and because of psychological spillover effects in other sectors of the economy. Furthermore, such raises would make it nearly impossible to provide income tax cuts for the low-income earners, thus undermining the existing social consensus for moderation in wage growth with very harmful consequences for further employment growth and competitiveness.

A final point I would like to stress is the need for on pension reform, especially in the public sector. It is important to start thinking about the long term in good times like today. Using the fiscal surpluses toward a transition to a fully funded system in the public sector would be a step in the right direction, revealing the true cost of public service in the long run.

Mr. Pickford made the following statement:

I commend Ireland for its remarkable economic performance. 1997 was the fourth consecutive year of strong growth, investment, and employment; a record which is all the more impressive when considering the low levels of inflation, a surplus in the public finances, and a growing current account surplus. Growth in 1998 shows no signs of waning. Unemployment continues to fall and, finally, long-term unemployment rates have begun to decline.

Given this background, it is hard to be critical. But there are a couple of areas of concern that need to be addressed. During last year's discussion, we raised concerns about signs of overheating within the economy, and about the robustness of the Social Partnership Agreement, and its ability to continue to deliver wage restraint. With inflation beginning to pick up, these concerns have intensified. The goal of the first stage of EMU entry has now been achieved, but tying the Irish economy to a common euro monetary policy will place an increased burden on fiscal policy. The main challenge that the Irish authorities will face in the coming year is to restrain domestic demand and hold inflation down, against a background where monetary policy will be significantly looser. The cut in Irish interest rates, which was announced last week, is merely the start of a process of bringing the Irish rates into line with other Euroland countries in advance of the introduction of the euro in January of next year. With only ten weeks left to the start of the single currency, Irish rates are still significantly above the levels in Germany and France. Further substantive cuts, probably by 200 basis points or more, will be required, at a point in the cycle when normally the authorities would have been looking to tighten policy. Fiscal policy will therefore need to become countercyclical rather than procyclical.

In response to the strength of economic activity, the pickup in inflation has meant that Ireland has gone from having one of the best inflationary records within the European Union to being one of the poorer performers. While the staff notes that in an accounting sense the depreciation of the exchange rate was a main contributory factor behind the pick up in inflation, the economy looks as if it is still showing signs of overheating, and there seems to be upward pressure on domestic prices and wages. Asset prices have soared in the last 18 months and they have the potential to add to inflation. They also carry prudential risks. While both the authorities' and the staff's research suggests that the boom in equity and house prices primarily reflect structural and demographic factors, it is dangerous to underplay the risks posed by sharp increases in asset prices. While capital adequacy ratios of Irish banks remain healthy, the scale of credit expansion in recent times and the pace at which asset prices have been rising could trigger a significant rise in bad loans. The authorities have already taken some welcome measures to reduce pressure in the housing market by increasing the supply of land and reducing the incentives for speculative investment in housing. But I wonder if more could be done in this area.

The other main source of inflationary pressure is the labor market. In recent years, the social partnership arrangements have played an important role in maintaining low wage growth and producing a wide ranging support for policy change. These are important, but I wonder whether such restraint can be sustained since unemployment has fallen sharply. While in the past tax cuts have been an important part of the overall package to deliver wage restraint, in current circumstances further tax cuts will be harder to deliver as fiscal policy has to bear the brunt of macroeconomic adjustment.

Since the Irish authorities will no longer have the option of adjusting monetary policy, fiscal policy will need to be more proactive. In current circumstances, fiscal policy should not be allowed to contribute further to the buildup in inflationary pressure, but rather should prevent it. If tax cuts, nevertheless, are felt to be essential to ensure wage restraint, the opportunity should be taken to target reforms at the lower end of the income scale, and remove some of the structural barriers to employment.

Before the introduction of a national minimum wage, a detailed assessment of the likely impact on job creation should be made. A minimum wage which is set too high could discourage job creation, and hamper the poorly qualified school leavers from entering the labor market.

Mr. Jadhav made the following statement:

With a fellow Indian Prof. Amartya K. Sen getting the Nobel Prize for Economics, I am so overwhelmed with joy that I have almost forgotten what I was going to say today. But I will try.

Our chair would like to compliment the Irish authorities for their steadfast pursuit of stability-oriented macroeconomic policies and outward-looking development strategies while emphasizing social consensus aimed at harmonious industrial relations. These policies have been immensely successful in Ireland as is evident from sustained and exceptionally strong growth performance, low inflation, declining unemployment and surpluses on the fiscal as well as external current account.

The Irish economy is placed today in an enviable situation characterized by the following features: real GNP growth in the recent years has been nearly as much as three times the average growth in the EU; the investment ratio is well above the EU average; the unemployment rate has declined sharply from the peak of 1994 and is presently well below the EU average; and the general government to GDP ratio has come down dramatically in the 1990s.

We broadly agree with the thrust of the staff report and the contention that short-term economic prospects for Ireland remain bright. We also share the authorities' view that threats to sustainability of growth emanate mainly from the success rather than failure of past economic policies. Accordingly, we would like to confine our attention to a few issues and making some observations that, in our view, are germane to the further evolution of the Irish economy:

The consumer price inflation appears to be raising its ugly head. On a harmonized basis, the year-on-year rate of increase in CPI, which was among the lowest in prospective EMU members is now among the highest. The asset price inflation has also accelerated sharply, of late. While the useful analysis in Box 1 attributes the asset price inflation mainly to structural and exogenous factors, it has been recognized that the easy availability of credit at historically low interest rates has also played a role. It is also noteworthy that GDP in 1997 was about 3 percent above the level compatible with stable inflation and that the gap reached a historical peak in 1997.

These developments are symptomatic of the risks of overheating generated by years of sustained strong growth and as such, the authorities would have to remain vigilant for signs of emerging strains.

Ireland has a unique distinction of having an exceptionally large gap between GDP and GNP. Moreover, the gap seems to be widening further in the recent years. While profits and royalties accruing to foreign multinationals have been cited as a proximate cause (p.7, footnote 1), the staff may kindly offer a more detailed explanation based on the structure of the economy.

Box 2 (p.12) provides an interesting analysis of fiscal consolidation in Ireland over a longer time span. Against that backdrop, the situation for 1998 clearly reveals that revenues were more buoyant than anticipated while spending was generally on track, leading thereby to an upward revision in the official projection for the surplus. This implies a fiscal contraction; yet, the staff paper states that, "...the 1998 fiscal stance clearly entails a significant stimulus that could have been avoided" (para 15, p.13). The staff may kindly explain.

The staff report notes that the decision of mid-March, 1998 to revalue the Irish pound by 3 percent did little to offset the nearly 10 percent decline in the effective exchange rate that had occurred in the preceding 12 months. While the authorities do not seem to disagree with the notion that the Irish pound may be undervalued at current exchange rates, the reasoning offered in para 21 (p.15 and 16) appears to be farfetched. A fuller explanation of the rationale would be welcome.

A multi-year centralized wage agreement, i.e., Partnership 2000, has been a cornerstone of social consensus in Ireland—securing pay restraint and industrial peace, in exchange for tax cuts and increasing social spending.

The Irish authorities have fulfilled their commitments under P2000, a full year ahead of schedule. We would like to know the circumstances that might have prompted advancing the fulfillment. The staff may also like to explain the possible implications of this action for the consensus process, especially in the context of next agreement.

Despite exceptionally strong growth performance for years, it is deeply regrettable that Ireland's official development assistance (ODC) has remained virtually unchanged at a low level of around 0.3 percent of GNP. Further progress toward the UN target is long overdue.

With these remarks, we wish the authorities all success in their policy endeavors.

Mr. Prader made the following statement:

The staff's and the Board's praise for the accomplishments of Ireland's economic policy is fully justified. We encourage the Irish authorities to continue with their steady implementation of sound macroeconomic and structural policies that have yielded extraordinary results for the Irish economy.

Over the past 10 years, Ireland has recorded growth rates not equaled in the rest of Europe since the 1950s and early 1960s. Moreover, this trend seems certain to continue, given the expansionary impulses coming from the earlier substantial exchange rate depreciation, which was only partially offset by the recent revaluation. We join the staff in pointing out that controlling inflation and public spending will be essential to the continuation of sustainable high growth and sound public finances. This task will not be easy. One of the main sources of the Irish economy's success, the social partnership, which together with tax policy has played a central role in moderating the wage bargaining process, might become a source of demand for higher government spending. It is reassuring to see that the Irish authorities are using a large part of the increased revenues resulting from the strong economic growth for rapid repayment of outstanding public debt, rather than for increased public spending and tax relief, but the pressure toward higher government spending and cost increases is evident. It will be in the interest of both policymakers and the social partners to continue public sector wage control.

Mr. Milleron made the following statement:

First, I cannot help but congratulate our Indian colleague for this good news, good news for India, but it is also good news for any citizen of the world. I think that the fact that Professor Sen got this Nobel prize for his work on poverty in particular is certainly important for all of us today.

Let me say first that it is very refreshing to talk about a booming economy, and something which may be a success story for all of us. In this spirit, I would like to comment on this report. This report is a very good one. It is well presented; it is compact; it is legible. Maybe if I could make, with your permission, one suggestion. It is interesting to see at the end the selected economic indicators for the basic data from national accounts. It is useful to have the growth rates of the various data, but the level of the main aggregates is really interesting, and I would like to invite you to have a look at Table A1 in the selected issue document on page 54. Looking at the last column in this table, we have to realize that we are talking about a country in which, after a remarkable growth in exports, the level of exports is approximately equal to the level of GDP. The ratio export-to-GDP is equal to 1, and I would like to remind you that when we talk about the possibility of adapting to external shocks, this ratio is very important. We will go back to that on fiscal policy issues. As a consequence, the order of magnitude of internal demand is approximately equal to imports overall. That is, the orders of magnitude we should keep in mind in the overall discussion of the case of Ireland.

At this stage, I must say that I feel comfortable with most of the remarks that were presented by the Austrian and British chairs, so I will not try to repeat, and maybe I would like to add some nuances.

On interest rates, certainly we have to be careful, considering the fact that we are in a trend of credit growth that is something like 20 percent per year. The change that is still before us with the decrease in interest rates could have some effect in terms of inflationary pressure. On the other hand, it is interesting to note, and that is not independent of my previous points, the fact that the United Kingdom and the United States represent, if I am correct, more than a third of Irish exports, and in these two countries we may expect a slowdown of activity. What is the exact balance between these elements? I would like the staff to help us understand better how these factors compensate or do not compensate.

Second, on fiscal policy, we are aware of the effort and it is impressive to see that Ireland easily fulfills the so-called Maastricht conditions. A question is, in the case of a country like Ireland, in the new framework with EMU, will fiscal policy be sufficient in case of adverse external shocks? And, fiscal policy also has to be analyzed taking into consideration issues related to public debt, and in particular external public debt. My second question could be formulated like that: do we now have sufficient room for maneuver in terms of possible adaptation to external shocks? What are the possible dangers for the Irish economy in the next five years, and in case of external shock do you have, as a European, sufficient room for maneuver to adapt through fiscal policy, or will you consider other handles to try to adapt in case of adverse external shock? That is my second question.

Finally, and that is more a question of information, I wonder how you will reach the long-term equilibrium of your pension system. I understand that your pension board has recommended setting up a fund for financing future pension costs. How will it work concretely? How would it be implemented, and if we could know a little more about that, I think that especially for many European countries around this table, those could be very interesting issues, also, to discuss.

Mr. Pascual made the following statement:

I must add my voice to those who praise the Irish model. The results have been impressive. In fact, it has been an enormous success so far from which we have much to learn. My congratulations to the Irish authorities and the society as a whole.

However, this being said, we are now in a particularly complex juncture which I do not know whether the authorities and the staff have had the opportunity to analyze in all its consequences. I am referring to the new international framework brought forth by the Asian and Russian collapse. I understand that these events have been taken into consideration to assess the present policy stance and to discuss and come along with a strategy to release demand pressures and create a comfortable buffer to face the exigencies of the SGP, while reducing the tax burden, especially on the supply of labor. But we are talking here, maybe, about a deeper and longer crisis affecting not only the economic outlooks of a substantial part of the world but also the international flows of capital and the major currencies exchange rates.

Within this new economic framework, I strongly believe that the discussions should be focussed not only on the dangers of a possible overheating of the economy but also on the international consequences of very conservative recommendations when the world economy needs thrust.

This does not mean that I do not worry about the future of Ireland-on the contrary. But I strongly believe that under the present circumstances, the risk of overheating is less worrisome and more unlikely than the risk of recession in the world economy and its consequences in Ireland.

Having said that, I must admit that I do not dare to propose a substantial change in the present policy stance envisaged by the authorities. I do not have the data or the knowledge of the Irish economy so as to assess the true impact of the crisis on them. Besides, some of the measures proposed are also applicable regardless of the situation of the world economy.

Nevertheless, I would feel better if the thrust of the consultation were focussed at least partially on the strategy to follow in case the downside risks become reality.

In this regard, I would ask the staff whether it has reassessed the likelihood of the scenarios with the last data available and whether their conclusions modify their initial recommendations. I am referring specifically, on the one hand, to the U.S. dollar and sterling downward trends, and the reduction of foreign direct investment and demand, and, on the other, the possible reduction of interest rates in the euro area. Knowing that these forces operate in opposite directions, I would like to know which, in the staff's view, are going to prevail and what the results for Ireland can be, and what the most appropriate policy response could be.

To conclude, I just want to assert my conviction that the authorities will do it fine. They have demonstrated it in the past and they will do it again in the future, even in a more stringent framework of policy action and in a more unstable world. I encourage them to take appropriate actions in their challenges ahead, especially in addressing the future endeavors of the pension system and in the labor market. In this regard, I would recommend the authorities to deal with special care the issue of the establishment of a national minimum wage. Although it is a matter of understandable social concern, its implementation could produce perverse consequences for job creation. In any case, if it is decided to put it into practice, it should contain specific provisions for certain sensitive groups—youth, new entrants, long-term unemployed—so as to allow for flexible contracts. Solving these problems and adopting a flexible and responsible policy-making approach in the uncertain short-run, the future will be a continuation of the successes of the past.

Mr. Hansen made the following statement:

Let me at the outset—like other speakers—say how impressed I am by the performance of the Irish economy in recent years. Without exception, progress has been enviable: high economic and employment growth, low inflation, an increasing current account surplus and now also general government balance in surplus. In an article on Ireland in 1997, Professor Paul Krugman at MIT explained that the positive developments were due to good luck, good timing and good policies. Yet, according to a commentary in the *Financial Times* last Thursday, now luck runs out, policies change, and the timing of EMU is not at all good for Ireland. The commentary maintains inter alia that Ireland, on its current performance no longer qualities for EMU on inflation grounds. Whereas this may give an overly pessimistic outlook for Ireland, notably since the inflation figure for September displayed a decline in the 12-month rate compared to August, it nevertheless indicates that Ireland faces considerable challenges ahead, if the benefits of the strong reform and stabilization efforts in recent years should be sustained and developed further.

I agree with Mr. Milleron that the staff report covers, in a comprehensive and well-balanced manner, the challenges and the policy options facing Ireland. I am broadly in agreement with the staff appraisal, and I will only make a few comments.

First, on monetary policy. with short term interest rates determined mainly by conditions in Germany and France, hardly anyone would argue that a common monetary policy for EMU suits Ireland well at present. Thus, to keep the interest rate unchanged to year-end seems sensible, even though the effect may be primarily symbolic as convergence has been built into expectations. As regards the revaluation of the exchange rate in March 1998, it may have been too small, based on the remaining wage and price pressures. Hence, a possible real appreciation may now come through domestic inflation instead.

On fiscal policy, a lot has been achieved as regards consolidation of public finances. However, I am somewhat doubtful with respect to the procyclical element, introduced by the government's contribution to the incomes policy, which appears to be present in the current framework. Moreover, I can easily follow the arguments for more ambitious fiscal objectives than presently pursued, presented by the staff in the selected issues on challenges ahead for fiscal policy. Seen in the light of the limits set by the Stability and Growth Pact and possible asymmetric shocks, the current cyclical position, as well as the future need for operation of automatic stabilizers and discretionary measures, speaks in favor of tighter fiscal policy today. For the future, it is important to ensure that the incomes policy not unduly restrain the countercyclical use of fiscal policy. Finally, the currently favorable demographic profile should be used as an opportunity to prepare for the long term challenges that eventually will arise for Ireland too, in much the same way as for other industrialized countries.

As regards the wage or incomes policy, I am certainly aware of the importance it has played in the successful overall economic policy in Ireland in recent years. Whereas I believe it is essential to preserve and extend the positive elements of the social partnership, I am not completely convinced that the continued reliance on general tax cuts to keep wage growth down is appropriate as a major tool to contain inflationary pressures. While the policy of wage moderation has been effective in the tradable sector, it has been less so in the nontradable sector. Recent wage developments in the public and building and construction sectors seem to reinforce this impression.

Therefore, the tax cuts on personal income, with its apparently moderating effect on wage costs in the tradable sector, may mainly have contributed to increased profit shares in this sector. While this probably entailed a normalization of the profit share in indigenous industries, the profit share in the high tech industries, where foreigners are active, is presently very high. Low tax on profits has compounded this effect.

A tax policy supporting a high profit share in the tradeable sector, while at the same time eroding the stabilization gains through strong wage increases in the nontradable sector, could very well challenge the social partnership in the longer run. Hence, an overall further firming of fiscal policy in 1999, with income tax reductions only for the low-paid to reduce poverty and unemployment traps, would to me seem worth considering. This would also reduce the need to introduce the national minimum wage the Irish authorities now are considering. Indeed, I share the concerns aired by the staff on this issue, where they question whether a national minimum wage is the most efficient way to deal with poverty and income inequalities.

On a more general note with respect to the fiscal stance, I recognize the potential political difficulties in raising fiscal surpluses further. Maybe Ireland would benefit from developing alternative fiscal indicators, that may well show—taking into account all relevant factors—that the present surplus implies a considerable stimulus to the economy.

In conclusion, I would like very much to associate myself with Mr. Spraos' and Mr. Wijnholds' remarks that, when looking at the Irish economy, one runs out of superlatives. Determination, social cohesion and a hard-working and well-educated labor force are among the factors that have brought Ireland into the group of best performers, a development with so many favorable aspects that I think it is a source of inspiration to all of us.

I wish the authorities all the best.

Mr. Al-Turki made the following statement:

Let me then join other speakers in thanking the staff for a clear and insightful analysis of the Irish economy's outstanding record and policy challenges. The authorities' strong policy commitment continues to pay off. Last year, growth reached some three times the European Union (EU) average and inflation, though up, remained subdued. While the outlook also remains buoyant, vigilance is essential to ensure containment of the boom within the economy's capacity limits.

A soft-landing has to be engineered, in the face of the expected sharp drop in interest rates for convergence to levels within the Economic and Monetary Union (EMU) and the authorities' commitment to tax cuts under the P2000 agreement with social partners.

Given the interest rate and tax stimuli, the onus for a soft landing is clearly on further expenditure restraint. The staff provides valuable suggestions in that regard for a fiscal strategy aimed at not only stability and growth but also longer-term structural improvements. Here, I fully endorse the stress on resisting pressures for excessive increases in public service wages. I also agree that the favorable fiscal position should enable a smoothing of the burden of funding pension costs.

The recent upturn in prices underscores the importance of the authorities' priority for continued low inflation. However, it is also important to look beneath the aggregates for a balanced appraisal of the forces underlying the pressures on prices. The authorities' care to discriminate between the evident bubble in share prices, the more structurally grounded rise in housing prices, and the relatively moderate pace of increases in goods and labor market prices is, therefore, welcome.

The disaggregated approach to inflation has helped the authorities to focus on the steps necessary to cool off the housing boom and ensure prudence in self-management of the financial system. Continued close monitoring of the inflation structure is clearly crucial for Ireland in view of the dangers of understating the economy's growth potential. Indeed, given the limitations of the usual output gap and NAIRU estimates, avoidance of excessive concerns over an economy's overheating risks requires a wider use of this report's disaggregated approach to inflation in Fund consultation reports.

As the staff rightly points out in Box 3, the outlook for Ireland's small open economy remains heavily dependent on developments abroad. It should also be noted that the staff's baseline scenario is based on a continued fairly rapid growth in foreign demand that appears quite optimistic in the light of the latest WEO projections. As pointed out by Mr. Milleron, this underscores the importance of maintaining a competitive edge through continued containment of the incipient pressures on wages and prices.

Finally, I welcome the recent upturn in Ireland's Official Development Assistance and, like Mr. Jadhav, urge the authorities for further progress toward meeting the UN target.

With these words, I wish the Irish authorities' continued success.

Mr. Elhage made the following statement:

We join other Directors in commending the Irish authorities for the excellent record of sound macroeconomic policies and structural reforms that have been maintained for over a decade. The impressive performance of the economy which continued through 1997 and the first half of 1998 is well documented in the staff report. We note in particular the important fiscal gains as reflected in the growing fiscal surpluses that have been achieved following a long period of fiscal consolidation.

However, in the period immediately ahead, emerging inflationary pressures, which Directors had cautioned against during last year Article IV consultation discussion, are clearly putting pressure on the authorities to seek an appropriate fiscal stance. This stance needs to be set in the context of a longer term fiscal path that would permit the operation of automatic stabilizers within the provisions of the Stability and Growth Pact. This is particularly important given that Ireland's business cycle is out of sync with the rest of the Euro area and that it is subject to relatively higher output fluctuations, further increasing the need for discretionary fiscal intervention.

As we are in broad agreement with the staff appraisal in what follows we will limit our comments to a few points basically for emphasis.

Sound fiscal performance is critical for maintaining the favorable conditions of the Irish economy. Accordingly, we welcome the conduct of fiscal policy which aims at removing the fiscal stimulus in order to address overheating of the economy and to lower the tax burden. To attain these objectives it is important that the authorities adhere to the 4 percent ceiling for the growth of net current spending. However, with monetary conditions exogenously determined and in fact at present time over expansionary, we believe that the authorities should be ready to further tighten the fiscal stance if signs of overheating persist or intensify. Additionally, in order to dampen demand growth, we encourage the authorities to resist the emerging pressures to increase public service employees' wages.

Before turning to structural matters, we have a question relating to the revaluation of the Irish pound. The staff argues that a larger revaluation might have been appropriate in light of the concern over inflation and the growing current account surplus. We would appreciate the staff's views on whether the possibility of further revaluation was still open before the beginning of 1999.

Turning to labor market issues where despite significant recent gains in employment, some challenges remain: in particular, the authorities' need to address the coexistence of labor shortages for skilled and unskilled workers with a high rate of unemployment. In this regard we welcome the measures taken to strengthen the incentives of the unemployed to take up jobs especially at the low end of the labor market. The continuation of education and training programs will be crucial for reducing shortages. Reducing the number of people on government-sponsored job creation schemes certainly seems to be worth exploring as a means of easing the shortages in the labor market. On the issue of a national minimum wage, we have no problem with establishing such a minimum if it does not interfere with the smooth functioning of the labor market.

With these remarks we wish the authorities success in maintaining the economy's favorable performance.

Mr. Szczuka made the following statement:

Ireland's economic performance, underpinned by the sound macroeconomic management, remains admirable and deserves praise. Rapid output growth has led to significant gains in employment while inflation, though edging up in 1998, has stayed at a relatively low level. At the same time, the fiscal position continued to improve with the general government balance turning to surplus in 1997. While the short-term economic prospects remain favorable, the Irish authorities are confronted with the very difficult task of assuring a "soft landing" of their economy, which shows already some early signs of overheating. This task is complicated by the challenges resulting from Ireland's participation in the EMU and by the unstable external environment. In addition, the difficulties with obtaining a precise estimate of the potential growth of the Irish economy considerably reduce the usefulness of this tool in guiding macroeconomic policies. In the medium term Ireland will also have to adjust to the expected reduction in the net transfers from the EU budget, while in the long run the problem of unfunded social security obligations will have to be properly addressed. One can also expect that the increased pressures on reducing tax competition within the EU will lead to decreasing inflows of foreign direct investments.

I fully agree with the staff that the loss of autonomy in monetary policy resulting from EMU membership underscores the importance of appropriately tight and flexible fiscal policy which ought to be supported by the adequate flexibility of the labor market. Tight fiscal policy and wage moderation are needed to restrain the domestic demand and contain inflationary pressures which are expected to be exacerbated by the easing of the monetary conditions in the run up to EMU. At the same time the flexibility of fiscal and wage policies is needed to increase the resilience of the Irish economy to possible external shocks. This resilience in Ireland is weaker than in most other EU countries due, among others, to the high degree of openness of the Irish economy, large dependance on FDI and EU aid flows and less diversified export and production structures.

I agree with the staff that there was no justification for an even slightly expansionary fiscal stance in 1998 and I support the authorities' plan to withdraw the fiscal stimulus in 1999 by containing the growth in expenditures. I attach particular importance to eliminating the traditional slippages in spending on pay increases in the public sector. I would also suggest proceeding cautiously with further income tax reductions, e.g., by making them dependent on further price and/or external developments. With respect to the long-term fiscal viability I support the proposals to use the current fiscal surpluses to accelerate the reduction of the public debt, thus making room for the financing of future deficits of the pension schemes. At the same time every effort should be made to resist the potential demands for temporary reduction of the pension contribution rates and a timetable for increasing these rates in the future or, alternatively, a move to a fully funded pension system should be considered.

The emergence of labor shortages despite the still relatively high level of unemployment stresses the importance of undertaking further measures to reduce the rigidities of the labor market. These rigidities are to some extent masked by the recent reversal of traditional emigration and increase in immigration to Ireland. Given the importance of real wage flexibility for demand management and for the ability to absorb external shocks, the authorities should aim at striking the right balance between assuring this flexibility and the viability of fiscal position, on the one hand, and maintaining the well-proven benefits of social partnership in setting the wage policies, on the other. In this context I have serious doubts as to the appropriateness of introducing the proposed minimum wage (including a reduced but fixed wage for young employees) and setting it at such a high level. On the other hand, I fully support the proposed measures aiming at assuring moderation in public sector pay increases and at strengthening the enforceability of eligibility requirements for unemployment benefits.

> Before concluding I would like to ask a few questions relating to Ireland's external position. First of all, I would like to join Mr. Spraos in requesting the staff to provide a more detailed explanation of the developments in the capital account of the balance of payments in 1997. What were the reasons for the more than fivefold increase in private capital outflows and how to explain the huge "net residual" item amounting to 2.45 billion punts (almost 7 percent of GDP). I would welcome also a broader assessment of the strength of Ireland's overall external position taking into account the continuous deterioration of the balance of invisible transactions and the possibility of reduced inflows of FDI's and EU funds. Finally, I would like to know what explains the significant reduction of the share of EU countries in Ireland's exports and imports in the years 1992–97 (from 77 to 66 percent, and from 69 to 54 percent, respectively) despite the substantial progress in EU integration during this period.

The staff representative from the European I Department noted that the growth performance in 1998 was somewhat stronger than had been indicated in the staff report, and the Central Bank of Ireland had recently revised its estimate of growth upward. The outlook for 1999 had become somewhat less sanguine, reflecting mainly weaker prospects for exports following a downward revision in the forecast for the growth of foreign demand and a moderate appreciation of the Irish pound in the past few weeks in nominal effective terms. However, interest rates in the EU area as a whole, were no longer expected to firm in the course of 1999 and there might even be some easing of interest rates. On balance, economic growth in 1999 was expected to be somewhat lower than the staff had anticipated when drafting its report. Nevertheless, growth was still expected to be well above what the authorities and the staff considered sustainable.

The size of the current account surplus supported the view that the exchange rate might be undervalued, the staff representative remarked. Further, relative unit labor costs and the evolution of export market shares suggested that Ireland's competitive position was strong.

The prospective decline in short-term interest rates in Ireland would not be a major monetary shock, as it had been anticipated for some time, the staff representative noted. Moreover, its impact on aggregate demand was likely to be weaker than historical experience would indicate, as one of the main transmission channels through—which declines in interest rates had operated in the past—namely, the exchange rate channel would no longer be operative, the staff representative noted.

Although conventional indicators suggested that the operation of fiscal policy had had a moderate restrictive impact on growth in 1998, a tighter stance would have been desirable, the staff representative said. In particular, it would have been helpful if the tax cuts had been less significant, given the ongoing relaxation of monetary conditions and the strength of economic activity and domestic demand. Unless there was a further deterioration in the international environment, further fiscal tightening should be pursued in 1999.

Ireland had reached a structural budget position that should allow automatic stabilizers to operate fully in the future in the event of adverse shocks, the staff representative considered. Nevertheless, longer-term considerations made it desirable to aim for sizable fiscal surpluses in the period ahead.

The staff had not studied the pension issues in sufficient detail to offer specific recommendations, the staff representative stated. There was, however, an important difference between pension arrangements the public service employees and the social security pension scheme. The government had a contractual obligation to bear the cost of any future increases in public service pension outlays. Given that obligation, it would make sense to move as quickly as feasible toward advanced funding of at least the new accruing pension liabilities of the state vis-à-vis its own employees.

For the social insurance pension scheme, the situation was more complex because there was no similar obligation of the state, the staff representative observed. Other changes could be introduced to address the prospective increase in pension outlays, for example, indexing pensions to inflation rather than future wages, or not indexing them at all. Before any decisions were taken in this respect, it would be important to study all alternatives.

The staff had expressed support for Partnership 2000, because such partnerships had worked well in the past, the staff representative remarked. Moreover, in contrast with other centralized wage agreements, this social contract did not seem to have contributed to any significant compression of wage differentials in Ireland. Nevertheless, it was important to ensure that future arrangements of this kind were not obtained at a cost that would limit fiscal flexibility or add to demand pressures in the short run.

To avoid adverse effects on employment, the minimum wage should not be set too high, the staff representative noted. It would also need to provide for sufficient differentiation to take into account the fact that productivity for some groups was lower than for others.

Official statistics were not sufficiently detailed to allow for a complete answer to the capital account puzzle, the staff representative said. Ireland currently had a current account surplus of 3 percent of GDP, and there was an inflow of foreign direct investment of 3–5 percent of GDP. The implied gross outflow of capital in 1997 was approximately 7 or 8 percent of GDP. About 2 percent of GDP of the outflow was accounted for by the repayment of foreign currency denominated debt of the government. Another 2 percent of GDP was accounted for by portfolio disinvestment by nonresidents, specifically liquidation of former investments in Irish government securities. The remaining outflows were accounted for by direct investment by Irish firms abroad, lending by the Irish banks to nonresidents on a net basis, and portfolio investment by Irish residents abroad, including institutional investors.

Mr. Daïri noted that the balance of payments net residual was 6 percent of GDP in 1997; he wondered what was behind that unusually large residual position.

The staff representative from the European I Department replied that at least part of the explanation was that inflows of foreign direct investment had not been properly accounted for so far. Although a large part of foreign direct investment inflows was financed from retained earnings, the component financed from foreign funds was perhaps understated in the present balance of payments statistics. There may also have been additional as yet unrecorded inflows, such as portfolios investments, as well as some understatement of the current account surplus.

The staff's medium-term growth projection of 4.9 percent was based on a careful analysis of the longer-term growth potential by a research institute in Ireland, which had concluded that the potential rate of growth was 5 percent, the staff representative observed.

The authorities and the staff had originally considered that estimate to be overly optimistic, but given the continuing strong performance of the Irish economy, it was now widely accepted as realistic.

The preferential corporation tax rate could have been a significant explanatory factor for the strength of foreign direct investment in Ireland, although it was probably becoming less important with the passage of time, the staff representative said.

Mr. Daïri wondered whether tax convergence could make the passage to EMU more rewarding for Ireland.

The staff representative from the European I Department stated that an agreement had recently been reached between the European Union and the Irish authorities to move toward a unification of corporation tax rates, whichwould be implemented over a period of years. The agreement would entail a gradual decline in the standard rate of corporation tax to bring it closer into line with the preferential tax rate that applied to the manufacturing sector and some financial services.

Mr. O'Loghlin noted that the average of the residual of the balance of payments account over the past six years was closer to 1 percent of GDP, as opposed to the 6 percent figure in 1997.

Irish exports had expanded substantially, so the decline in exports to Europe did not affect Ireland significantly, Mr. O'Loghlin said. One of the explanations of the decline of exports to Europe was that agriculture output and exports had been relatively static, and that agricultural exports tended to go to Europe rather than elsewhere.

Mr. Newman made the following statement:

> I will try to be brief at this stage. In the study Mr. Hansen referred to earlier, Paul Krugman characterized Ireland as the first really regional economy of Europe with, as Mr. Milleron mentioned, shares of exports and imports exceeding GDP and a labor mobility that is far greater than most countries in the world. Given the openness of the economy, I tend to share the view of those Directors who would expect that the appreciation of the virtual euro and the deterioration in the external environment is likely to have a greater effect on Ireland than the staff may be anticipating, which would suggest that Irish luck in this case is still holding up.
>
> Similarly, I share the skepticism of those regarding the sustainability of the social pact in the context of a much slower growth environment, and in particular whether it can be sustained in the context of potential conflicts between the needs for the economy for fiscal flexibility to deal with lower growth, and the requirements of the Stability and Growth Pact. I see there is going to be a tension between these two or three factors that are going to be more difficult to reconcile in the future than they have in the past.
>
> There was, however, one issue which I do not think has been discussed very much in the context of this Article IV, and concerns the role that labor mobility has played in both sustaining the social compact and in easing the

fiscal pressures by helping to hold down wages. As we know, in the past when Ireland has had bad times, they have been very successful in exporting labor and these old emigrants are now becoming new immigrants as the economic environment has substantially turned. This has contributed to the labor pool which has helped to restrain wage increases, particularly in some of the more high tech sectors where they are getting the largest influx of labor recently. I would be interested in the staff's views as to how significant an impact this has had on the wage formation process, on the sustainability of the social compact, and on easing the fiscal pressures, both in the past as and as they see it going forward. Moreover, given the emphasis we have been placing on the need for labor market flexibility and mobility in the context of EMU, I was wondering if there were any particular lessons to be drawn from the Irish experience that might be more broadly applicable to the rest of Euroland.

Mr. Donecker made the following statement:

Ireland has achieved remarkable economic progress during the last years, thanks to its considerable efforts, but also thanks to its European Union membership. However, major challenges remain, such as the further reduction of the number of young and unskilled unemployed, the containment of inflationary pressures, and further policy adjustment to the new challenges of stage three of the European Monetary Union. There is also a need for vigilance with regard to fiscal policies and wage developments. The latter is particularly important in view of the Irish economy's size, structure, cyclical position, and the advent of stage three of EMU.

The major challenges for the near future are combating the inflation risks and bringing about a soft landing of the economy. Ireland faces a demanding task since the monetary policy of the ECB must respond to the needs of the euro area as a whole rather than to the potentially divergent requirements of one country. Therefore, the authorities will have the difficult task to combat inflationary pressures without having independent monetary instruments available. The most recent interest rate cut highlights the dilemma for the Central Bank of Ireland. Despite inflationary pressures and high credit demand, interest rates were reduced in preparation for EMU. We therefore welcome the intention of the authorities to pursue a firm fiscal policy to contain inflation, and to gain more room for maneuver in the future. With the budget already in surplus, it will be necessary to firmly withstand continued pressures by various groups, such as public employees, to increase public expenditures. We see only limited room for tax cuts since the authorities must be alert to avoid any further expansionary fiscal impulses at this stage. If signs of overheating persist or intensify, the authorities should be ready to tighten their fiscal stance.

Mr. Zakharchenkov made the following statement:

I agree completely with those directors who commended the Irish authorities for the excellent performance of the country during the past years. It is notable that the highest growth rate in the EU was achieved by Ireland within a framework of low inflation, a contained budget deficit and a sound current account position. Also impressive is the fact that these results have been achieved in a very open economy. As has recently been stated by a senior Irish finance ministry official: "We export everything that we produce and import everything that we consume. You can't get much more open than that." (Here I refer to the same article as Mr. Hansen and Mr. Newman.)

Indeed, there is little to add to the staff papers and to the views expressed by other speakers, so I will limit myself to only a few points regarding long-term growth perspectives.

Our primary concern is about the easing of monetary conditions following the EMU entry. Given the increased risks of inflation, we welcome the government's decision to limit the monetary easing that EMU poses for Ireland by delaying the convergence of Irish interest rates to the levels prevailing in core-EMU countries "for as long as possible." In light of the escalation of asset prices and the need to contain private credit expansion, the recent measures to cool off the housing market and to enhance prudential supervision of credit institutions are also commendable.

In the absence of monetary instruments the main burden of containing inflation and preventing overheating of the economy will be placed on fiscal policy. Ireland has demonstrated an impressive track record of fiscal adjustment. However, the staff papers provide an impression that the Irish government has relatively little flexibility because of its income policy. The government is locked into a deal with trade unions that envisages wage moderation in return for income tax cuts and increased social outlays. Moreover, aging of the population will also add some pressure on the budget in the period ahead. In this regard, we welcome the objectives of the announced 1999 budget and the authorities' firm commitment to pursue sound fiscal policies. It is commendable that, according to Mr. O'Loghlin's statement, the country is on track for a general government surplus of about 2 percent of GDP this year.

The Irish success is based significantly on inward FDI channeled into export-oriented activities. In this connection, I share Mr. Spraos's point regarding the negative capital account balance. Indeed, the scale of this phenomenon in the case of Ireland is unusual. Although I believe that the attractiveness of Ireland to foreign investors is deeply rooted, it would be interesting to hear from the staff how things might evolve in the long run when the foreign capital inflow ceases to expand, or even contracts.

Although the short-term unemployment rate in Ireland has reached a historically low level and is below the OECD average, both youth and long-term unemployment remain high. However, from Mr. O'Loghlin's statement, it is clear that this issue is being addressed by the authorities, including expected income tax cuts and other structural reforms aimed at strengthening job incentives and further enhancing the flexibility of the labor market. Hopefully, these measures as well as the Employment Action Plan, which was announced earlier this year, will reverse the situation.

With these remarks I wish the Irish authorities well.

Ms. Wang made the following statement:

Mr. O'Loghlin mentioned in his helpful statement that 1997 proved to be another very positive year for the Irish economy, and I, in turn, would like to repeat this chair's commendation for the Irish authorities' continuous impressive economic performance. I find myself in general agreement with the staff's appraisal, and would like to concentrate my comments on several points for emphasis.

First, the most obvious challenge facing the Irish authorities is the increasingly evident inflationary pressure, which leads to intensified bottlenecks in labor and infrastructure, the rapid increase in domestic credit and asset prices, as well as increasing the strain on the social consensus embodied in Partnership 2000. With the approach of the launching of the euro and the perceived sharp easing of monetary policy, the major policy instrument available for the authorities to contain inflationary pressures is fiscal policy. In this context, it is encouraging to learn that the 1998 fiscal performance is expected to be on track for a general government surplus of about 2 percent of GDP, and that the announcement by the authorities of the primary objective for the 1999 budget will be the maintenance of low inflation. While faced with the continuing claims by public service employees for large pay increases, the authorities are encouraged to be sure to meet their commitment not to exceed public expenditure targets for 1998.

Second, on the income tax cut. The authorities' commitment to cut income tax by 2 percentage points under the Partnership 2000 has been fulfilled in advance. Given the increased demand pressures on inflation, it seems that any further income tax cut should be limited to the extent permitted by the strict observance of the ceiling on current expenditure growth as stipulated in the government's medium-term program, and the cut should focus on the lower income group.

Third, although Ireland is a relatively wealthy country, compared with other industrial countries, it seems that poverty is a major problem for the authorities. Great progress has been made in the alleviation of poverty through increased employment and government social expenditure. However, the reduction in long-term unemployment, which is believed to be the main cause of poverty, is still slow, and the authorities are encouraged to strengthen their efforts in focusing policies to empower people to move out of poverty situations. In this context, the reduction in income tax, particularly the tax rate for the lower income group, and the implementation of various schemes in areas of education and training to ease skill shortages and facilitate the reintegration of the unemployed in the work force, is welcome. While generally agreeing with the staff, that in view of the tight labor market conditions, the scope for reducing direct official involvement in job creation should be explored, we believe that government involvement in job creation for long-term unemployment should be strengthened.

Finally, on ODA, it is welcome that the growth rate of ODA contribution by the Irish authorities is faster than that of the GNP. However, the Irish authorities are encouraged to increase their ODA contribution according to the UN standard.

With these remarks, I wish the Irish authorities further success in the future.

Mr. Daïri made the following statement:

Like other Directors, I thank the staff for a well-structured paper. Since I concur with the thrust of the staff's appraisal, I shall only comment briefly on a few points.

The Irish authorities are to be commended for their successful macroeconomic management during the past decade, which helped them achieve a sustained and remarkable economic growth with a low rate of inflation and a declining rate of unemployment. The Irish economy is a good example of how a country can draw high dividends from pursuing appropriate economic policies and promoting social consensus.

It is encouraging to note that, for the first time in the last decade, the authorities could register in 1997 a surplus in public finance. Also, the budgetary surplus is projected in 1998 to be higher than the initial figure. Strong economic growth accounts for the higher-than-expected current revenue in 1997–1998. At the time of entering the EMU, more fiscal tightening will be required in order to comply with the EMU requirements and to face output shocks.

The authorities should also be more vigilant lest inflationary pressures build up in the economy. A demand stimulus by tax cuts and supportive credit expansion has brought prices under pressure. I concur with the staff that the needed tightening of macroeconomic stance will have to rely on fiscal policy in the period ahead as interest rates are expected to drop further with the advent of the EMU. I agree with Mr. Pickford on the need to closely monitor the strength of the financial system in the context of large credit expansion and asset bubble. I also wonder if a combination of tighter fiscal policy and stringent prudential regulations regarding loan-to-value ratios is not more appropriate for addressing the present asset bubble rather than relying solely on fiscal consolidation. I also appreciate staff's comments on the authorities' progress in their privatization efforts. I am encouraged by Mr. O'Loghlin's statement that early action is necessary to address issues of ageing public service and population even if Ireland is expected to be affected later than other countries.

Finally, I would like to commend the Irish authorities for the increase in ODA and moving toward meeting the UN goal.

Mr. Belay made the following statement:

We will be brief in our comments. We commend the Irish authorities for their success in recent years in pursuing appropriate economic policies. Ireland has continued to make enviable progress in reforming its economy as is evident in the significant growth gains, declining inflation, and markedly strengthened fiscal and external balances. We encourage them to sustain this progress in the years ahead. In this regard, it would be important to contain the recent price pressures and to ease the emerging strains on resources before they become intensified and threaten the gains to be made in various areas of economic activity, and to remain watchful of signs of such strains in the coming years.

We would also like to express our appreciation to the Irish authorities for their continued official development assistance (ODA) to developing countries and for their generous contribution to the ESAF/HIPC Trust Fund.

We wish them success in their future endeavors as participants in the EMU.

Mr. N'guiamba made the following statement:

We would like to join previous speakers in praising Ireland for its strong macroeconomic performance of the last four years. This performance has been evidenced by a rapid expansion of economic activity; a low inflation rate, despite a recent upward transitory trend; a surplus in the external current account; and the creation of new job opportunities. The Irish authorities certainly deserve to be commended for having created favorable conditions for this performance essentially through their adherence to stability-oriented macroeconomic policies and the adoption of an outward-looking development strategy documented by their ability to attract large amounts of foreign direct investment.

As we look forward, we note that, while these encouraging trends are likely to persist, the authorities are presently confronted with the problem of inflationary pressures that have recently resulted mainly from the generous tax cuts and continued public expenditure slippages. In that context, Mr. O'Loughlin's statement is helpful in indicating that the acceleration of consumer price inflation has tapered off in recent months. In that regard, we believe that the revaluation of the Irish pound was a contributing factor, as it eliminated the risk of a further significant depreciation in the run-up to EMU. We are also of the view that, in order to bring inflation under control, it would be essential to use fiscal policy instruments and supply-enhancing structural reforms in order to restore some balance between supply and demand.

We are encouraged to note that Ireland contemplates giving high importance to the pursuit of sound fiscal policy, particularly after the upcoming introduction of a single currency in the European Union in January 1999. To that end, it is important for the government to resist claims by various groups of public service employees for large pay increases. As regards the budgetary operations of the government, it is our view that it would be useful to further streamline the tax system and reduce tax reliefs in order to compensate for the revenue loss that results from the lowering of personal income taxes. In addition, the authorities' intention to address the problem of the "aging population" and its impact on public finances is welcome.

On structural reforms, we share the view that the authorities should focus on strengthening the labor market through appropriate reforms. Steps to enhance economic efficiency are also encouraged, particularly with the view of examining the economic merits of retaining public ownership of certain essentially commercial activities. In that context, we note that plans for the privatization of state-owned companies had been stepped up after the change of government in June 1997 and that new initiatives had been announced to increase competition, notably in the services sector. Concerning the particular case of the financial institutions, the fact that resources devoted to prudential supervision had been increased, on-site inspections had been intensified and there had been frequent warnings to maintain prudent lending practices, represent steps in the right direction.

Finally, countries in our constituency are appreciative of the development assistance that Ireland has provided to them in the past. However, they do hope that this assistance will increase with the improvement in Ireland's economic and financial performance.

With these remarks, we wish the Irish authorities further success in their macroeconomic management, particularly after the introduction of the Euro during the months ahead.

Mr. Costa made the following statement:

I commend the performance of the Irish economy which had high rates of growth, high job creation, low inflation, and a marked reduction of public debt. However, to the extent that the tax factor and the large subsidy from the European Union have been significant explanatory variables of this outstanding performance, there may be a degree of unrealism about the overall positive outlook of the Irish economy. Could the staff perhaps comment on how the European Union subsidies are accounted for in the budget.

The authorities should concentrate on structural reforms, especially in the labor market. Particular attention should be paid to the creation of incentives to increase employment of the youth and the long-term unemployed. Fiscal policy should be used to slow growth and to avoid an overheating of the economy. Perhaps a more aggressive use of regulations in the banking area to reduce the strong expansion of credit could be helpful to slow growth, and to alleviate the risks of asset price inflation.

Mr. Bernal made the following statement:

We join previous speakers in thanking the staff for their very analytical and well-presented reports on the Irish economy. We must congratulate the

Irish authorities for the impressive economic results achieved. Since 1994, Ireland's economic output, investment, and employment grew at rates that are admirable. Export performance was impressive and unemployment fell to its lowest level in nearly two decades. These developments have been based on stability-oriented policies, which brought public finances to a surplus for the first time in recent history. To this performance, in addition to the role played by macroeconomic management, foreign investment has also contributed importantly, as well as the high degree of social consensus, reflected in the income policy agreements.

The key goal of short-term macroeconomic policy is to moderate the pace of aggregate demand to avoid the risks of overheating and the resulting inflationary pressures. Signs that inflation is likely to accelerate will have to be monitored closely. At present, the proposed fiscal stance for 1998–99 appears consistent with non-inflationary growth and with the need to further consolidate public finances. The authorities should not miss the opportunity to keep up the pace of fiscal adjustment now that macroeconomic conditions are favorable. From the staff documents, as well as from the illustrative Buff statement by Mr. O'Loghlin, it is clear that the authorities will take advantage of any opportunity to further consolidate public finances under the envisaged favorable macroeconomic conditions. Under EMU fiscal policy will be called upon to play a greater role than in the past in dampening cyclical fluctuations in economic activity and dealing with asymmetric shocks. A sizeable fiscal surplus is advisable if room for discretionary fiscal interventions is to be retained, given the volatility of output in the Irish economy, as exports and industrial output are not as well diversified as those of the more advanced EU countries, and because of the strong trade and financial links with the United Kingdom.

With these remarks, we would like to wish the authorities every success in their endeavors.

The staff representative from the European I Department said that Ireland had recently experienced a net inflow of workers, which had alleviated the upward pressure on wages. The net inflow of migrant workers, however, accounted for only a small proportion of the overall increase in employment. The natural growth in the working age population was the most important factor behind the growth in employment. There had also been a gradual increase in female participation rates.

Ireland's progress toward reducing tax wages and the net replacement rates had been important in increasing the flexibility of the labor market and contributing to the rapid growth in employment, the staff representative noted.

The authorities should not be imposing prudential standards currently, in particular on loan-to-value ratios, the staff representative considered. However, if credit growth continued to expand at rapid rates, and concerns about the soundness of the banking system became more acute, further prudential regulations would be conceivable.

Property taxes had been abolished only a few years ago, but could be reconsidered if pressures in the housing market did not ease, the staff representative remarked.

Not all European Union transfers entered the budget, as some transfers were subsidies to farmers that were channeled through the intervention agency, or directly from the European commission to farmers or exporters, the staff representative noted. Other European Union transfers did enter the budget, of which a substantial part went to the capital budget.

The degree of state involvement in economic activity was not high in Ireland, the staff representative remarked. The present government was more open to state disengagement from economic activity. There were some plans for the privatization of state assets, and the local authorities were planning to reduce their direct involvement in economic activity.

Mr. O'Loghlin observed that the critical issue for Ireland was to manage expectations because of the budget surplus. It was no longer easy for the authorities to call for expenditure restraint when new initiatives were brought to the table because the budget was in significant surplus. The authorities were of the view that the social contract had been extremely useful. It was essential for the authorities at this juncture to resist high public sector pay claims.

The staff paper suggested some fundamental reasons underpinning the increase in house price , Mr. O'Loghlin stated. The authorities had taken strong action to alleviate some of the pressures. For example, interest costs on borrowing for property investors could no longer be deducted. There were indications that the rate increase of housing, was dropping.

Regarding European Union subsidies, approximately two-thirds of them were market-based and did not pass through the budget, Mr. O'Loghlin said. The total turnover of government activities in the economy was less than 6 percent of GDP. The authorities were not predisposed against privatization or against decreasing the government share in the economy.

The share of GDP devoted to official development assistance has risen by half over the period of Ireland's economic success, Mr. O'Loghlin observed.

The Acting Chairman made the following summing:

> Executive Directors agreed with the thrust of the staff appraisal. They commended the authorities for Ireland's impressive economic performance, as evidenced by five consecutive years of vigorous growth in activity and employment, a strong fiscal and external position, and—until recently—a low rate of inflation. Directors emphasized the important role that good economic management had played in sustaining this favorable performance and ensuring Ireland's participation in EMU from its inception. While most Directors shared the view that short-term macroeconomic prospects remained generally favorable, some expressed concern that the worsening in the global environment would—if sustained—have a significant adverse effect on Ireland, given the openness of its economy.
>
> Directors noted that the authorities were now confronted with some new, and difficult, policy challenges. These stemmed in part from the comparatively advanced stage of the business cycle in Ireland, which was reflected in the emergence of signs of overheating, as well as a sharp rise in asset prices and increased wage pressure in the public sector. But the challenges were being compounded by the competitive exchange rate that

Ireland appeared to enjoy at the onset of EMU, and the prospective downward convergence of Irish short-term interest rates to the much lower rates prevailing in the core EMU countries. In this regard, Directors underscored the need for adequate and timely responses to these challenges in order to keep the economy on a path of sustainable growth in output and employment, with price stability over the medium term. Directors considered the main policy requirements to be, first, a tightening of fiscal policy to offset the stimulus to demand from the easing of monetary conditions; and, second, continued emphasis on structural reforms in order to alleviate labor and other supply constraints.

Directors welcomed the authorities' commitment to allow the unanticipated buoyancy of revenue in 1998 to be reflected in a higher than budgeted surplus, but stressed the need for tight expenditure restraint to ensure that the fiscal stance in 1999 would contribute to the containment of inflationary pressures. Directors agreed that the recent progress in streamlining the tax system and reducing tax relief needed to continue. Most Directors thought that, in the short run, room for lowering the income tax burden might be limited unless there was firm evidence that excess demand had been eliminated. In any case, Directors noted that, were income tax cuts to be enacted in 1999, these should be directed to strengthening work incentives for the low paid in order to help ease labor shortages and improve prospects for wage restraint.

Directors welcomed the authorities' intention to seek to extend the social partnership arrangements which had worked well in the past, but they stressed the critical importance to a satisfactory new social contract of resisting ongoing claims from various groups of public employees for large pay increases. Such increases could undermine continued cost moderation in the economy, and are inconsistent with the continuation of the impressive employment and economic gains of recent years.

Directors agreed that keeping public spending in check was the key to ensuring a sizeable fiscal surplus over the medium term. Such a surplus, they stressed, would facilitate compliance with the Stability and Growth Pact and provide room for fiscal flexibility, as warranted in view of the loss of monetary autonomy. Moreover, it would allow Ireland to make early progress toward addressing longer-term pressures on the public finances associated with the aging of the population and the unfunded contingent liabilities of the current pay-as-you-go public pension system. Directors urged the authorities to take the opportunity afforded by buoyant economic conditions to incorporate at least the full accruing costs of public service pension liabilities in future budgets.

Directors expressed concern about the rapid growth of credit to the private sector, which had contributed to the recent strength of consumer spending and the escalation in housing prices. In view of this concern, they understood the authorities' reluctance to lower short-term interest rates rapidly, and welcomed the measures recently taken to cool off the housing market and strengthen the supervision of financial intermediaries. A few

Directors stressed, however, that additional efforts were called for in both areas.

While praising Ireland's recent outstanding record in creating jobs, Directors stressed the need for further progress in increasing labor market flexibility, in order to sustain the downward trend in unemployment and facilitate macroeconomic adjustment in the event of adverse shocks in the future. Most Directors emphasized, also, the importance of enforcing strict conditionality requirements for unemployment benefits, particularly for young workers. They also pointed out that the continuing high levels of long-term and youth unemployment make it critical that a minimum wage, if introduced, be appropriately differentiated to minimize possible adverse employment effects on those categories.

Directors commended the authorities for their ongoing efforts to increase competition in the economy, including through an accelerated privatization program. They also welcomed the recent decision to move gradually toward a unified corporation tax rate.

Directors noted the recent increase in Ireland's official development assistance and encouraged the authorities to increase further their development assistance. Directors stressed the need for improvement in the area of statistics, particularly the coverage of wage trends and capital account transactions.

It is expected that the next Article IV consultation with Ireland will be held on the standard 12-month cycle.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/98/105 (9/30/98) and EBM/98/106 (10/14/98).

2. BULGARIA—ACCEPTANCE OF OBLIGATIONS OF ARTICLE VIII, SECTIONS 2, 3, AND 4

The Fund notes with satisfaction that, with effect from September 24, 1998, Bulgaria has accepted the obligations of Article VIII, Sections 2, 3 and 4 of the Articles of Agreement. (EBD/98/103, 10/7/98)

Decision No.11811-(98/106), adopted
October 13, 1998

3. ASSISTANTS TO EXECUTIVE DIRECTORS—BENEFITS PROCEDURES

The Executive Board approves the proposal regarding benefits for Assistants to Executive Directors as set forth in EBAM/98/164 (9/28/98).

Adopted October 1, 1998

4. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAM/98/149, Supplement 1 (9/29/98), EBAM/98/165 (9/28/98), EBAM/98/167 (10/1/98), EBAM/98/169 (10/1/98), EBAM/98/171 (10/6/98), EBAM/98/172 (10/8/98), and EBAM/98/174 (10/9/98), by Advisors to Executive Directors as set forth in EBAM/98/166 (9/29/98), EBAM/98/167 (10/1/98), EBAM/98/169 (10/1/98), EBAM/98/172 (10/8/98), and EBAM/98/174 (10/9/98), and by Assistants to Executive Directors as set forth in EBAM/98/169 (10/1/98) and EBAM/98/170 (10/5/98) is approved.

5. TRAVEL BY MANAGING DIRECTOR

Travel by the Managing Director as set forth in EBAP/98/100 (10/8/98) is approved.

APPROVAL: December 13, 1999

SHAILENDRA J. ANJARIA
Secretary