Private and Confidential

Minister from Secretary General,

1. The purpose of this note is to summarise my views on the key and immediate strategic challenges that will require your early attention and that of the Government. These relate in the main to stabilisation of the fiscal and banking situations within the framework of the EU/IMF Programme of Support.

2. A detailed manual covering each area of the Department's responsibilities is also attached. This covers many of the major policy issues across the Department that will need to be addressed in the coming weeks and months. My colleagues and I are available to brief you on any of these issues at your convenience and we also stand ready to engage with you and your cabinet colleagues on these matters as appropriate.

Principal Economic Policy Objectives

3. The key objectives of policy must be to support domestic confidence and begin the process of restoring international confidence in our economy. These are necessary to stabilise the economy and provide the basis for net employment creation and, as a consequence, tackling our high unemployment rate. Essential prerequisites are:

(i) Continuation of the restoration of budget sustainability over the coming years, through ongoing fiscal consolidation, i.e. bringing our deficit down to below the 3% of GDP.
(ii) Stabilisation of the banking system.
(iii) Improvements in competitiveness and reforms to improve competition and reduce costs.
(iv) Sectoral measures and investments to boost output, employment and reduce unemployment.

4. There are a large number of micro issues under (iii) and (iv) that need to be pursued. These will help to reduce costs and support export-led recovery. There are also a range for sectoral measures that could be implemented to support activity and employment in different sectors of the economy. Our views on some of issues are set out in the briefing attached and my colleagues will be happy to discuss with you.

5. While these 4 essential prerequisites form the central part of the EU/IMF Programme of Financial Support, I would like to focus most of my comments on issues (i) and (ii) above.

EU/IMF Programme of Financial Support

6. The two overarching macro economic policy issues we face are the funding of the State and the funding and stabilisation of the banking system.

7. The agreed EU/IMF Programme of Financial Support for Ireland sets out the key aspects of medium-term budgetary and banking policy. The arrangements for this Programme, as currently provided for in the *Memorandum of Economic and Financial Policies* (IMF) and the *Memorandum of Understanding* (EU/ECB), include strong conditionality and reporting requirements relating to fiscal consolidation, financial sector reforms and structural reforms. We believe that through dialogue there is scope for you and the new Government to review and modify aspects of this Programme in consultation with our External Partners (the IMF, EU and ECB). In this regard, the forthcoming first policy review mission, tentatively scheduled for early April, will provide a formal opportunity soon for modification. However, in terms of what changes can be achieved, it is important to state that in order to ensure on-going funding of the State and support to our banking system we must meet the Programme's fundamental conditions and ensure that we address the serious macroeconomic imbalances that we face.

8. Addressing these imbalances will over time enable us regain the trust of the international community and facilitate our re-entry into international markets. At this [redacted].

9. In terms of the day-to-day management of the Programme, it is important that you are aware that there is constant monitoring of Ireland's performance against the agreed policy benchmarks by the Partners. For example:

- there are weekly Official level discussions between myself and the principals of the "Troika";
- data are provided on a weekly basis under several headings by the Department, Central Bank and NTMA;
- strict deadlines have been set for key deliverables under the Programme;
- any proposed deviations from the Programme are notified to the Partners with the identification of countervailing policy measures (the recent Finance Bill is a good example).

- to monitor delivery, formal quarterly reviews are undertaken in Dublin which involve the IMF/EU/ECB (often in excess of 20 plus people), the Department, several other Government Departments in respect of sectoral reform, the Central Bank, the Regulator and the NTMA; and
- in addition to the formal quarterly reviews, so far since we have entered the Programme, we have had a number of "on-the-ground" technical missions involving various teams from the EU/IMF and ECB.

10. All of the foregoing necessitates significant and ongoing interaction between the political and administrative systems here and the External Partners. In this regard, the Department has established an External Compliance Programme Unit to manage and coordinate the running of the Programme, an update note is now a standing item on the agenda of the weekly Departmental Management Advisory Committee meetings and Government is updated every other week on progress under the Programme as well as highlighting potential risks. Finally in this regard, Cabinet procedures were amended so that all Government memos are now to include an assessment as to the potential impact of all policy proposals on the EU/IMF Programme of Financial Support.

Key issues

11. Key issues relating to the EU/IMF Programme of Financial Support are:

- fiscal policy and funding of the state; and
- bank recapitalisation and deleveraging.

Fiscal Policy

[redacted]

[redacted]

14. In terms of our fiscal objectives for 2011, these were set out in Budget 2011 and, as you know, have already been broadly provided for with the passing of the measures underpinning that budget. The Department of Finance's budget day assessment of the

economic and fiscal position, based on information available up to end November, identified negative risks to the domestic side of the economy with some positive risks associated with the external side of the economy. Since then, the limited information that has come to hand would suggest that, in fact, the domestic side of the economy may well be weaker this year than thought. If this is the case, then there may be some negative consequences for the fiscal position. However, as against this, the exporting side of the economy is performing more strongly than previously thought and this is a positive. We will have more up to date information later in March and the Department will then formally reassess its Budget day forecast in advance of submitting to Government a draft of Ireland's Stability Programme Update in advance of submitting it to the EU Commission by April 2011.

15. [redacted].

16. Difficult decisions will be required in all areas of policy over the period ahead as we aim towards a medium-term primary surplus (surplus excluding interest rates) necessary to stabilise our debt levels. The State has undertaken substantial expenditure consolidation over the period 2008-2011. Further reductions in expenditures will be required and achieving these will require firm control of pay and numbers, the cutting back of programme spending, and the abandonment of expensive large scale capital projects first mooted during the boom.

17. There will also have to be a continued focus on spending-cut efficiencies under Croke Park and in departmental administrative budgets and procurement. The scope for efficiencies is not unlimited and many efficiency measures have been commenced. Nevertheless, public sector reform has an important role to play in securing necessary savings and we will work with you in delivering a modernised public service.

18. The Government Programme contains a commitment to undertake a comprehensive review of spending. We fully support this and can brief you on how we believe work on this can commence.

19. As acknowledged in the document, spending reform is also a key element of Budget reform to secure better, more transparent and more informed decisions on the scale of overall spending and on the spending choices to be made. There is no room for extra spending in some areas unless matched by lower spending in others. We have prepared a comprehensive discussion document on reforming the budget process of which you may already be aware and which we consider will be helpful in this regard.

[redacted]

Debt Sustainability

21. The General Government debt is estimated to have stood at €148 billion or over 94% of GDP at end-2010. Budget 2011 forecast that General Government debt would stabilise at 102.5% of GDP in 2013 before declining thereafter. These projections are based on reducing the fiscal deficits to below 3% by 2014, further bank capitalisation and deleveraging costing €10 billion and assumptions about both growth and interest rates.

22. Overall, it is essential that this debt is stabilised in the short-term and this depends on: interest rates, growth rates, requirements to meet bank losses and the size of the State's primary balance. Restoring market confidence and our credit worthiness requires a resumption of growth and continuing with significant fiscal consolidation (i.e. achieving a primary surplus as quickly as possible).

[redacted]

[redacted]

[redacted]

[redacted]

26. [redacted]

Banking Position

27. A separate and more detailed note has been prepared for you on banking matters. However, the key issues are summarised in the following paragraphs. [redacted]

28. Overall, the Irish banking system needs to be significantly downsized and the EU/IMF package seeks to address the banking problem by ensuring the banks are highly capitalised (to meet possible further stress) and deleveraged to bring the loans and the funding more in line.

29. A Prudential Capital Assessment Review (PCAR) is determining what the appropriate level of capital should be in the viable banks. As a first measure, the EU/IMF Authorities requested that the financial institutions capital ratios be brought up to 12%. This was to be completed for most banks by end February with the State committed to providing up to €10 billion for this recapitalisation and early deleveraging. As you are aware, your predecessor decided not to inject any capital after the recent election was called and the External Partners are very anxious that that money be injected as soon as possible.

30. When the PCAR is completed, the capital will need to be increased, if necessary, to keep the ratios above 10.5%. This is emerging as a strong possibility and a document

which addresses this and other economic and financial risks is being submitted to you separately. Any decisions about further capital injections (including the cost of deleveraging) must take account of the overall solvency of the State as discussed above, the reality of the funding dependency on the ECB, the views of our External Partners and the potential for burden sharing with shareholders and bondholders.

[redacted]

32. A Prudential Liquidity Assessment Review is underway to establish a path to a smaller deleveraged but more stable banking system with a more appropriate funding base. [redacted].

33. **It is essential that policies recognise our dependency on the ECB and the implications this has for our room for manoeuvre and capacity for independent action.**

[redacted]In this regard, the issue of burden sharing with bondholders has some limited potential to minimise the costs for the Sovereign of future banking costs[1]. Burden sharing with subordinated debt holders has already yielded approximately €10 billion capital across the banks. [redacted]

[1] There are €16.4 billion in unguaranteed unsecured senior bonds in issue of which €3.75 billion of the total was sitting in Anglo Irish and INBS. A total of €6.2 billion of bonds across the system mature this year of which €1.0 billion is in Anglo/INBS.

[redacted]

[redacted]

[redacted]

EU Debates on Governance/Wider issues of EU response to the financial crises

37. Much debate has centred on the potential to reshape the EU/IMF Programme and, increasingly, discussions are part of a wider EU Response package to the financial crisis. The focus at EU level has shifted away from a country-specific response to a systemic response. Work is advanced on the design of a comprehensive response package to ensure financial stability in the euro area, including the establishment of a permanent financial rescue mechanism (European Stability Mechanism) to come into place in 2013 replacing the temporary European Financial Stability Mechanism. It is likely that action will be considered under the following headings:

- ensuring debt sustainability,
- enhancing the capacity to provide support to member states in distress,
- repairing the banking system, and

- improved economic governance.

38. Under EU Governance and Fiscal Reform, the proposals provide for sharpened Stability and Growth Pact arrangements with much greater emphasis on prevention, correction of budgetary difficulties in Member States and increased monitoring and enforcement by the European Commission. The so-called "European Semester" which seeks greater budgetary coordination and surveillance at EU level of all Member States' budgetary plans in advance has been agreed and gets under way this April. We have no major problems with these developments.

39. Proposals for a Competitiveness Pact which will be discussed by the Heads of State of the EU this Friday is a key upcoming priority. [redacted].

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

Conclusion

45. In conclusion, if we are to define the key focus of our economic strategy it should be to support domestic confidence and restore international confidence so that:

- the economy is stabilised,
- the basis is provided for net employment creation and, as a consequence, for tackling our high unemployment rate, and
- we exit the EU/IMF Programme of Support as soon as feasible.

March 2011