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Country update **IRELAND**

Summary

Economic stabilisation, restructuring and recapitalisation of the banking sector and the success of the government to stick to the agreements made with the IMF/EC/ECB in exchange for financial assistance have pushed government bond yields for Ireland below those of Italy. But uncertainty remains high, with economic recovery far from complete, a sizeable private debt overhang still to be dealt with and new austerity and reform measures becoming harder to agree upon in the governing coalition. Also, uncertainty remains regarding the restructuring of the recapitalization of the banks that was promised by the euro zone governments in July 2012, absent which government debt will remain very high, making the Irish public finances very vulnerable to adverse shocks.

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Ireland

National facts	
Type of government	Parliamentary democracy
Capital	Dublin
Surface area (thousand sq km)	70
Population (millions)	4.7
Main languages	English
	Irish (Gealic)
Main religions	Roman Catholic (87.4%)
	Church of Ireland (2.9%)
	Other Christian (1.9%)
Head of State (president)	Michael D. Higgins
Head of Government (prime-minister)	Enda Kenny
Monetary unit	EUR

Economy		2011
Economic size	*bn USD*	*% world total*
Nominal GDP	221	0.32
Nominal GDP at PPP	188	0.24
Export value of goods and services	231	1.05
IMF quotum (in mln SDR)	1258	0.58
Economic structure	*2011*	*5-year av.*
Real GDP growth	1.4	0.5
Agriculture (% of GDP)	n.a.	n.a.
Industry (% of GDP)	n.a.	n.a.
Services (% of GDP)	n.a.	n.a.
Standards of living	*USD*	*% world av.*
Nominal GDP per head	48919	451
Nominal GDP per head at PPP	41446	333
Real GDP per head	46419	568

Social and governance indicators	rank / total
Human Development Index (rank)	7 / 187
Ease of Doing Business Index (rank)	15 / 185
Index of Economic Freedom (rank)	9 / 179
Corruption Perceptions Index (rank)	19 / 183
Press Freedom Index (rank)	15 / 178
Gini index (income distribution)	34.3
Population below $1.25 per day (PPP)	n.a.

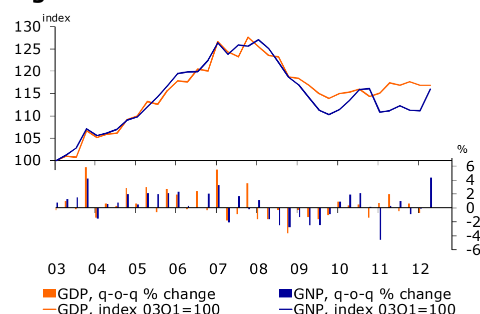
Foreign trade			2011
Main export partners (%)		*Main import partners (%)*	
US	21	UK	39
UK	16	US	13
Belgium	15	Germany	8
Germany	7	Netherlands	6
Main export products (%)			
Chemicals and related products, n.e.s.			60
Machinery and transport equipment			11
Food, drinks and tobacco			9
Raw materials			2
Main import products (%)			
Machinery and transport equipment			25
Chemicals and related products, n.e.s.			21
Mineral fuels, lubricants, and related ma			14
Food, drinks and tobacco			12
Openness of the economy			
Export value of G&S (% of GDP)			105
Import value of G&S (% of GDP)			83
Inward FDI (% of GDP)			6

Source: EIU, CIA World Factbook, UN, Heritage Foundation, Transparency International, Reporters Without Borders, World Bank.

Economic recovery held back by weak external environment

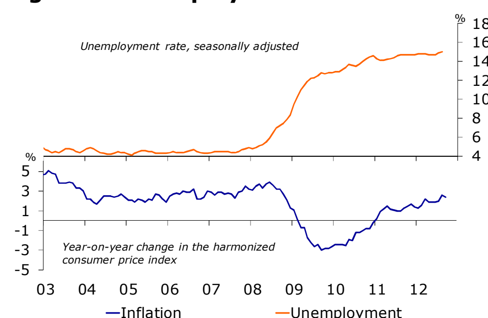
After three consecutive years of decline, the Irish economy returned to economic growth in 2011. Real GDP was 1.4% higher than in 2010. Of course, given the scale of the decline that came before that, the level of economic activity is still much lower than before the recession started (figure 1). On top of that, growth has been insufficient to halt the decline in employment. As a result, the unemployment rate has continued to move up, albeit in a more moderate pace than in previous years (figure 2). Gross National Product (GNP), which corrects GDP for flows in factor income and gives a better picture of the income earned by Irish labour and Irish owned firms, is significantly smaller than GDP in Ireland. This is the result of years of high net inflows of foreign (direct)

Figure 1: GDP and GNP



Source: Reuters EcoWin

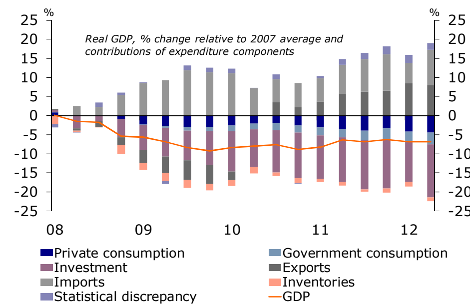
Figure 2: Unemployment and inflation



Source: Reuters EcoWin

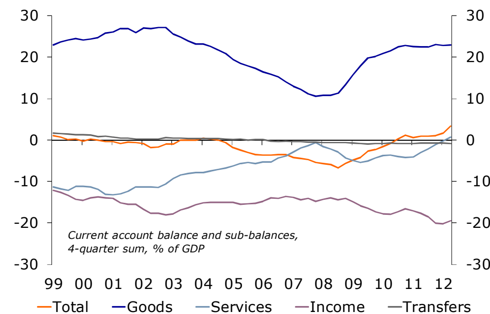
investment that has resulted in a large fraction of Irish production accruing to foreign owners of firms based in Ireland. The decline in GNP has been larger than in GDP during the first phase of recession and it has been slower to recover as well. This was to be expected, since the recovery in GDP has been driven primarily by exports (figure 3), which to a large extent are being produced by the foreign owned modern manufacturing and services industries. Even so, despite the rising net income outflows the current account balance was pushed back into positive territory (figure 4) on the back of rising exports and falling imports. Over the past year, the export performance of the services sector has been very strong. This is a very positive development since it points to the continued attractiveness of Ireland as an export base for international companies.

Figure 3: Expenditure contributions



Source: Reuters EcoWin

Figure 4: Current account deficit



Source: Reuters EcoWin

Given the need for household deleveraging and government austerity, any economic recovery was always going to be based on exports. The Irish return to growth stands in marked contrast to the recessions in Southern-Europe. But with economic growth in the main trading partners of the euro zone, the UK and the US still rather lacklustre, the Irish recovery has been disappointing so far.

We expect further modest GDP growth of around ½% this year. With slightly higher growth of the global economy overall and somewhat more favourable developments in the euro zone and the UK, export growth is expected to be somewhat higher next year, on the back of which economic growth can reach 1½%. Such limited growth rates mean that the level of GDP by the end of 2013 will still be more than 4½% smaller than in 2007. It is also not enough to materially bring down the unemployment rate.

Inflation returned to positive territory in 2011 (figure 2) and will continue to be supported by hikes in indirect tax rates in the short run. But a lower contribution from energy price inflation and a diminished effect of taxes will push inflation down next year. Continued high unemployment is likely to keep wage growth and inflation at very moderate levels for some years to come.

Best of class in Troika 101

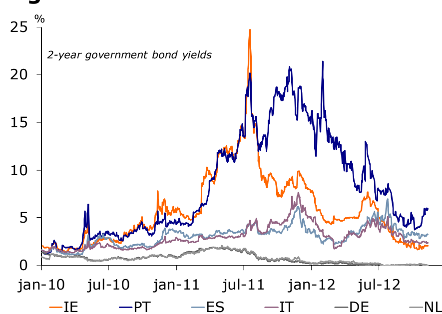
The Irish government has been able to deliver on all the agreements made with the IMF/EU/ECB troika for seven consecutive quarterly reviews. As a result, financing for Ireland's deficits and debt redemptions has been forthcoming without delay. The government remains committed to the adjustment program. But after budget adjustments over the past four years of about 8% of GDP, a further 5% of GDP in expenditure cuts and tax increases will have to be found over the next three years. This includes measures in pensions and health care needed to prepare the budget for ageing in the medium term. Given what has already been done, finding policies that can count on support from both governing parties will become increasingly hard. Illustrating this, coalition tensions over health-care measures have flared up over the past months.

Although we expect the coalition to be able to implement further austerity and reform, the task at hand is likely to increasingly test the strength of the coalition. Given the very high government debt load that has been built up, it will take years of continued budgetary discipline to push down the debt ratio over time. Although the policy performance of Ireland has been impressive up to now and has a good chance to stay strong in the years to come, the weak state of government finances will continue to make the country vulnerable to financial stress. Further adverse shocks will be hard to cope with and could eventually make default on government debt a necessary condition to put the government finances back on a sustainable path.

Back to market based financing

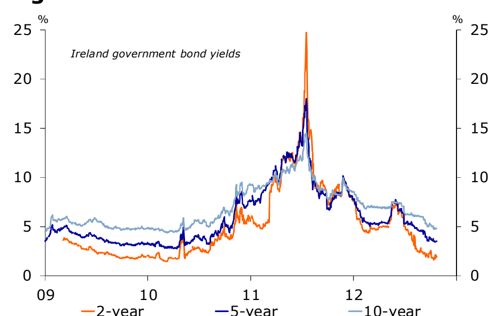
Ireland's success in abiding by the Troika conditionality, the economy finding a bottom from which to recover, sizeable budgetary adjustments and the restructuring of the banks has resulted in a marked fall in government bond yields. The shift in sentiment towards Ireland has been most marked in the two-year yield, which had already fallen from almost 25% in July 2011, to 4.5% in February 2012. After renewed unrest related to the uncertainty created by the elections in Greece, the two year yield fell further to about 2% in the course of September (figure 5). The fall in yields has been assisted by the formation of a pro-European government in Greece, which has reduced the risk of that country leaving the euro zone and with that has reduced contagion towards the Irish bond market. In a new positive development, recent policy uncertainty in Greece, that has pushed up Portuguese government bond yields, has not been visible in Ireland (figure 5). Also, the announcement by the European Central Bank (ECB) that they are willing to buy government bonds of countries that are in a European rescue package and abide by the conditionality of that package has played a role. The fact that Irish policies themselves have been very important in driving the shift in sentiment is illustrated by the fact that the entire Irish yield curve has fallen to levels equal to or below that of Italy. Yields are now back at levels last seen in the period prior to the first rescue package for Greece that was established in April 2010 (figure 6).

Figure 5: Interest rates



Source: Reuters EcoWin

Figure 6: Interest rates



Source: Reuters EcoWin

With its current cash reserves and the financing available under the rescue program, Ireland is fully financed until the end of 2013. The first steps back to market based finance have been set. In January 2012, part of a bond due in February 2012 was successfully switched into a bond maturing a year later. In early July, the country returned to the short term debt market, issuing 3-month treasury bills for the first time since September 2010. It has followed up on such sales in September and October, with the yield falling from 1.8% at the July auction to 0.7% for the October issue. At the end of July, they further switched bonds maturing in 2013 and 2014 for longer dated paper. More significantly, more than EUR 4bn of new bonds maturing in 2017 and 2020 were issued, the large majority of which was absorbed by foreign investors. In August, the debt management agency issued amortizing bonds with maturities ranging from 15 to 35 years

that cater to the domestic pension industry. Through the bond switches and the newly issued bonds, the treasury management agency has reduced a EUR 11.9% refinancing need that existed for January 2014 by more than 80%.

From 2014 on, the government will have to fully finance both redemptions and the government deficit. If yields and market access remain as favourable as they are now, Ireland should be able to prefund a significant part of 2014 financing needs in the course of 2013. Whether market circum-stances remain favourable will partly depend on euro area wide developments. Contagion from developments in Southern-European countries or a lack of progress in European institution building may push Irish interest rates back up, undermining the possibility of obtaining market finance at sustainable interest rates.

Should market access at sustainable interest rates be unavailable, further financial assistance will be forthcoming if Ireland remains committed to the macro-economic adjustment program. In a referendum, the Irish population voted in favour of signing the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, better known as the 'Fiscal Compact'. Signing this treaty is a precondition to obtain funds from the European Stability Mechanism. So apart from the positive sign for Irish attitudes about European integration and the euro, the yes vote has also kept open the road to possible further financial assistance. Such assistance may then be combined with Outright Monetary Transactions of the ECB to facilitate the return to full market finance for Ireland. We continue to think that a debt restructuring as part of further financial assistance remains a low probability event.

Still dealing with the banks and debt overhang

Ireland set up the National Asset Management Agency (NAMA) in December 2009 as a bad bank to relieve the banks of their non-performing real estate loans and to run down the portfolio of real estate assets that serve as collateral over time. Loans with a nominal value of EUR 74bn were bought at an average discount of 57% by NAMA in 2010 and the banks were recapitalized to com-pensate for the losses they incurred in the process. A Prudential Capital Adequacy Review (PCAR) was conducted in early 2011 to judge if banks would be able to withstand an adverse economic scenario. In the recapitalization exercise that followed, a contingency buffer for unexpected losses on top of the stress scenario has been taken into account. EUR 24bn was added to bank capital to ensure that they would be left with a minimum of 6% in core tier 1 capital in an adverse scenario. Up to now, actual developments in GDP, unemployment, non-performing loans and house prices are between the baseline and adverse scenario. As such, and given the contingency buffer, there is still some room for adverse economic developments before more bank capital would be needed to ensure stability.

The PCAR will be repeated in 2013. Of the EUR 24bn recapitalization effort that resulted from the 2011 PCAR, EUR 16.5bn was provided by the government. A further EUR 5.8bn was realized through burden sharing with subordinated bond holders and EUR 1.7bn private investment. As a result, the cost to the government has remained well below the EUR 35bn that was earmarked for bank recapitalization in the financial assistance offered by Europe and the IMF. This means that a possible further setback in bank capital needs that might result from the 2013 PCAR can still be absorbed in the current rescue package.

Although uncertainty remains, the banks have been put on a much sounder footing over the past years. But to enable the banks to support the economic recovery going forward, the challenge will

be to increase profitability and cope with the remaining excess debt in the system. There is still a large amount of household mortgages that have to be dealt with. Non-performing mortgages are still rising quickly and many households have debts that are much higher than the value of their house. Positively, house price declines, after having accelerated in 2011, have moderated substantially since March 2012. A new personal insolvency law will make it easier to restructure a mortgage for households that are unable to pay. Although this may push up losses for the banks, this is a necessary step to reduce the excess debt that is still present in the economy.

To date, the Irish state has committed EUR 63bn, or 40% of GDP to recapitalize the banks. The support to Anglo Irish Bank and Irish Nationwide Building Society, which have been merged into the Irish Bank Resolution Company (IBRC), has been most expensive. The largest share of the recapitalization of this institution has been done with EUR 30.6bn of promissory notes. These notes have already been counted in the government deficit and debt figures for 2010. But the funding for the promised annual payments will have to be forthcoming over the next ten years.

In consultation with the EU, the Irish government decided not to pay this year's principal on the promissory note in cash, but instead with a new 13-year government bond. This has reduced the Irish funding needs for the year. This method has been seen as a first step in a process of restructuring the promissory notes, with the goal of reducing Irish financing needs in the years to come and to lower the overall cost to the taxpayer of bailing out the banking sector. A more important change to the banking sector bailout would involve the European Stability Mechanism investing directly into the banks by buying equity stakes. According to the IMF, if the EUR 24bn of equity injected under the rescue program would be bought by the ESM, the proceeds could be used by the government to reduce gross government debt by more than 14% of GDP. This would markedly improve debt sustainability and would have a much more significant impact than a restructuring of the promissory notes alone.

A euro area summit statement of June 29 2012 indicated that the ESM will be allowed to directly recapitalize banks when a European bank supervisor has been established and specifically mentioned that "The Eurogroup will examine the situation of the Irish financial sector with the view of further improving the sustainability of the well-performing adjustment programme". Since then, however, dealing with legacy assets and retroactively recapitalizing banks has been ruled out by Germany, The Netherlands and Finland. As such, it remains rather uncertain in what manner and to what extent the burden to Ireland of supporting its banks will be relieved. In any case, the timelines of the proposed European banking supervisor are such that any decisions on direct recapitalization are some way off. We regard it as unlikely that Germany will agree to allow the ESM to directly recapitalize banks before their September 2013 general elections.

A significant change to the terms of the bank bailout would be very beneficial to the outlook for the Irish adjustment program. As we already mentioned, it has the potential to drastically improve the sustainability of Irish government finances. Next to that, it is important politically since there is a lot of popular and political resentment toward the current state of affairs. Lowering the cost of bailing out the banks will make it easier to continue on the path of austerity and reform. This in turn is important to keep Ireland on track to full market financing and economic recovery.

Conclusion

The Irish government is doing everything in its powers to strengthen the government finances, restructure the banking sector and stimulate economic growth. But the economic imbalances that

were built up prior to the crisis were so big that Ireland will be coping with the aftermath for a number of years to come. Further progress is needed and the country will remain very vulnerable to adverse economic shocks.

The success of the economic adjustment program is also crucially dependent on developments outside Ireland. Actually, the two high impact risks for Ireland that are identified by the IMF in its latest Article IV report are not under Irish control. A renewed intensification of the euro crisis would undermine growth prospects and has the potential to push Irish government bond yields back up. And if the promise to change the terms of the bank bailout is not implemented in a serious manner, the debt load of the government and the country will remain too high for comfort.

Ireland

Selection of economic indicators	2007	2008	2009	2010	2011	2012e	2013f
Key country risk indicators							
GDP (% real change pa)	5.4	-2.1	-5.5	-0.8	1.4	-0.1	0.3
Consumer prices (average % change pa)	4.9	4.0	-4.5	-0.9	2.6	2.0	1.0
Current account balance (% of GDP)	-5.4	-5.7	-2.3	1.1	1.1	1.5	1.4
Economic growth							
GDP (% real change pa)	5.4	-2.1	-5.5	-0.8	1.4	-0.1	0.3
Gross fixed investment (% real change pa)	2.2	-10.2	-27.6	-22.7	-12.7	-5.0	-2.5
Private consumption (real % change pa)	6.4	-0.1	-5.4	1.0	-2.4	-3.5	-1.5
Government consumption (% real change pa)	6.5	0.6	-4.4	-6.5	-4.3	-3.5	-3.5
Exports of G&S (% real change pa)	8.4	-1.1	-3.8	6.2	5.0	2.6	1.4
Imports of G&S (% real change pa)	8.0	-2.9	-9.7	3.6	-0.3	-1.1	-0.5
Economic policy							
Budget balance (% of GDP)	0.1	-7.3	-13.9	-30.9	-12.6	-8.8	-8.0
Public debt (% of GDP)	25	44	65	92	108	115	98
Money market interest rate (%)	4.3	4.6	1.2	0.8	1.4	0.6	0.4
M2 growth (% change pa)	6	-1	6	-8	-3	4	2
Consumer prices (average % change pa)	4.9	4.0	-4.5	-0.9	2.6	2.0	1.0
Exchange rate LCU to USD (average)	3.7	3.7	3.7	3.7	3.7	n.a	n.a
Recorded unemployment (%)	4.6	6.3	11.8	13.6	14.4	14.8	15.3
Balance of payments (m USD)							
Current account balance	-13876	-14954	-5243	2364	2484	3100	3000
Trade balance	27154	35015	45235	47435	50920	49200	49200
Export value of goods	115241	119172	108180	109604	118098	111700	113400
Import value of goods	88088	84158	62945	62169	67178	62520	64130
Services balance	-1536	-11279	-9615	-8810	-2519	800	2200
Income balance	-38138	-36993	-38882	-34388	-44304	-45300	-46900
Transfer balance	-1357	-1697	-1984	-1873	-1613	-1500	-1500
Net direct investment flows	4014	-34906	-285	8979	15604	3160	1640
External position (m USD)							
International investment position	-54360	-178940	n.a	n.a	n.a	n.a	n.a
Total assets	3341750	3039730	n.a	n.a	n.a	n.a	n.a
Total liabilities	3396110	3218670	n.a	n.a	n.a	n.a	n.a
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	10.5	13.3	20.1	22.8	23.0	23.6	23.5
Current account balance (% of GDP)	-5.4	-5.7	-2.3	1.1	1.1	1.5	1.4
Inward FDI (% of GDP)	9.5	-6.2	11.8	13.0	6.3	8.2	9.6
International investment position (% of GDP)	-21.0	-68.0	n.a	n.a	n.a	n.a	n.a

Source: EIU, IMF via Reuters EcoWin; the Economist Intelligence Unit estimates and forecasts for 2012 and 2013 do not necessarily represent Rabobank views and hence may deviate from the text

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