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Country report IRELAND

Summary
Even though the worst of the recession is over, the Irish economy is set for a very slow recovery this year and next. Domestic demand will still contract this year, but continued export growth should be able to compensate for that. Next year, domestic spending should act as less of a drag on GDP growth. Recapitalization and restructuring of the banking sector is well under way. But further unforeseen losses cannot be excluded. The government has been very successful in reaching the budgetary targets agreed with the EU and the IMF. A possible restructuring of promissory notes used to rescue part of the banking sector will both reduce financing needs and enhance popular support for harsh budgetary measures. On the other hand, with years of budgetary adjustment still to come, popular opposition is bound to increase. Although the government coalition boasts a comfortable majority in parliament, the economic and social backdrop will make putting the government finances on a sustainable footing a very hard job.

Things to watch:

- Economic developments in main trading partners given export dependence
- Government deficit reduction, popular opposition, social cohesion, political will and capacity

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Ireland

National facts	
Type of government	Parliamentary democracy
Capital	Dublin
Surface area (thousand sq km)	70
Population (millions)	4.2
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	218	0.32
Nominal GDP at PPP	185	0.23
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	0.7	0.0
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	52681	489
Nominal GDP per head at PPP	44565	361
Real GDP per head	49251	606

Social and governance indicators	rank / total
Human Development Index (rank)	7 / 187
Ease of Doing Business Index (rank)	10 / 183
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			2010
Main export partners (%)		*Main import partners (%)*	
US	21	UK	37
Belgium	15	US	14
UK	15	Germany	8
Germany	7	Netherlands	6

Main export products (%)	
Chemicals and related products, n.e.s.	57
Machinery and transport equipment	11
Food, drinks and tobacco	9
Raw materials	2
Main import products (%)	
Machinery and transport equipment	26
Chemicals and related products, n.e.s.	19
Food, drinks and tobacco	12
Mineral fuels, lubricants, and related materi	12
Openness of the economy	
Export value of G&S (% of GDP)	100
Import value of G&S (% of GDP)	82
Inward FDI (% of GDP)	13.1

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

Economy is past the worst but will have trouble recovering

After three years of falling economic activity, Irish real GDP grew by 0.7% in 2011. The unemployment rate has stabilised and hovered around 14.4% from the end of 2010 until February 2012. On these numbers, we can conclude that the worst of recession is over. But it is too early to talk of real recovery. GDP growth in 2011 hardly made a dent in the output losses of previous years. With 2011 GDP down 9.5% on the level of economic activity in 2007 and the unemployment rate more than 10%-points above its pre-crisis level, the Irish economy clearly has a very long way to go to recover previous levels of output and employment. Two important features of the Irish economy reinforce this message.

First, although unemployment was broadly stable in 2011, this was mostly the result of net emigration and discouraged jobseekers leaving the labour force. Employment fell by 2.1%. Employment did rise in the last quarter of 2011, ending a 15 quarter consecutive decline. But given the current economic weakness, we do not expect this to have been the start of an employment recovery yet.

Second, the modest growth of real gross *domestic* product was accompanied by a 2.5% decline in real gross *national* product (GNP). An important feature of the Irish economy is the big difference between GDP and GNP. Due to sizeable net foreign direct investment inflows since the 1990's, a large share of the firms operating in Ireland is foreign owned. The profits generated by these firms do not accrue to the Irish people and are not counted in GNP. As such, GNP is a better measure of

the income of Irish nationals. Export growth has been the only positive aspect of the economy over the past years. This has mainly benefitted the modern manufacturing and services sectors, which are for a large part foreign owned. As a result, the positive impact of growing exports has only partially accrued to the Irish people. The divergence in GDP and GNP was particularly harsh in 2011. As a result, while the 0.7% *rise* in GDP looks good at first glance, the 2.5% *drop* in GNP and the 14.3% fall since 2007 gives a rather more pessimistic, and for the Irish people very painful, view on last year's economic development.

In 2012, we expect a further modest recovery in real GDP. As such we are more optimistic than the Economist Intelligence Unit forecast given in the table below. Similar to 2011, we expect the recovery to be exclusively dependent on exports this year. Consumer confidence remains at very low levels. Households' real disposable incomes will decline further due to downward pressure on wages, lower government transfers and higher taxes. At the same time, house prices – having already been halved in nominal terms - are still on a steady downward path, further eroding household net wealth. As a result, the saving rate will remain high as households bring down debt or push up reserves to strengthen their balance sheets. We expect household spending to resume its downward trend in 2012. Therefore, domestically oriented businesses will see little reason to increase fixed investment. Government spending is expected to keep falling for the coming years.

In 2013, domestic demand overall is expected to act as less of a drag on activity. Coupled with higher export growth, this should mean that GDP growth accelerates relative to this year. Beyond that, even though returning to the growth rates seen before the crisis is not likely, Ireland's fundamental strengths, among which we see a flexible labour market, a relatively young and well-educated labour force, a high score on ease of doing business and a favourable corporate tax regime, should ensure continued growth in output and employment.

More transparency on bank rescue cost but uncertainty remains

The Prudential Capital Adequacy Review (PCAR) conducted last year resulted in a € 24bn increase in bank capital by mid 2011 with the objective of realizing a minimum 6% core tier-1 ratio in an economic stress scenario. In this recapitalization exercise, a contingency buffer for unexpected losses on top of the stress scenario has been taken into account. Of the total capital increase, €16.6bn was provided by the Irish exchequer and the National Pension Reserve Fund (NPRF). Set against the buffer of € 35bn in the IMF/EU financial assistance agreed in late 2010 and coupled with the contingency buffer, this still leaves quite some room for further setbacks regarding bank losses.

Then again, with the decline in house prices accelerating over the past year, and expected to remain on a downward trend throughout 2012, we cannot be sure that the current cost to the Irish state of recapitalizing the banking sector of in total € 63bn, or 40% of 2011 nominal GDP, is really the final tally. Next to further potential losses not taken account of in the stress test, it remains to be seen to which extent the National Asset Management Corporation (NAMA) will be able to run down the real estate loan portfolio obtained from the banks without a loss.

Government well on track but painful adjustment still lies ahead

The government budget deficit for 2011 is currently estimated at 9.4% of GDP excluding recapitalization of the banks, which is comfortably below the 10.6% target agreed with the IMF/EU. The headline deficit number including these recapitalization amounts to 13.1% of GDP. A

combination of expenditure cuts and tax hikes in the 2012 budget aims to ensure a further reduction of the budget deficit to 8.6% of GDP this year, as a further step towards the 3% target in 2015. The 1.3% real GDP growth assumption in the budget for 2012 seems somewhat optimistic. The difference with our own expectation of growth in the region of 0%-1% is not big enough to undermine the budgetary effort. Yet the economic backdrop will certainly make it rather challenging to keep up the impressive abidance by the budgetary agreements that Ireland has shown until now. To us, the recent sizeable non-payment of a €100 household charge does not point to a widespread and general rise in tax evasion. But it does testify to the challenge the government faces in the multi-annual budgetary adjustment and to the likelihood of increased popular opposition to austerity. The budgetary effort from 2008 up to and including 2012 has by and large had a bigger negative effect on the disposable income of higher income households. But the 2012 budget itself will be more severe for lower income households. Even though the budgetary adjustments will become smaller in the years ahead, they are set to continue until at least 2015. Popular opposition is likely to grow. Of course, with a comfortable majority in parliament and no elections until 2015, the Fine Gael/Labour coalition government will not necessarily be impaired by that in its budgetary efforts.

The successful budgetary strategy, the recapitalization of the banks and the signs of economic stabilisation have been very helpful in bringing down government bond yields in the secondary market. 10-year yields have hovered around 7% since early February 2012, from over 14% in July 2011. 2-year yields have fallen even more sharply, from a 24.9% high to around 5% more recently. As a first step back towards market financing, in January 2012 Ireland successfully switched 30% of a bond due in February 2014 for a new bond due in February 2015 to spread the refinancing needs. Although current bond yields are still too high for Ireland to finance itself in the capital markets in a sustainable manner, the lower rates do show that market sentiment towards its government debt has become much less pessimistic since last summer. Of course, part of the declines in recent months might also be attributed to the 3-year LTRO's that were extended by the ECB.

Ireland's financing needs are covered until at least the end of 2013 by the current rescue package. If market financing is not available after that, further financial assistance will be required to prevent default. That help will by then have to come from the permanent rescue facility European Stabilisation Mechanism (ESM). Signing the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, better known as the 'Fiscal Compact' is a precondition for receiving ESM funds. On May 30, the Irish will hold a referendum on this treaty. Although opinion polls suggest the population will vote in favour of the treaty, a vote against will make additional aid harder to come by. We do not rule out that if push comes to shove and if Ireland has abided by the conditionality of the first rescue package, a workaround to provide further aid will be found. But a rejection of the treaty will certainly increase the risk of default down the road. Our baseline expectation is for additional rescue funds to be forthcoming when needed and without a restructuring of privately held government bonds as has happened in Greece. As such, in contrast to what is expected by the EIU in the table below, we do not foresee a reduction in government debt through default next year.

A much discussed topic regarding both the financing needs and the total cost of bailing out the banks is € 30.6 bn of promissory notes issued to Anglo Irish Bank and Irish Nationwide Building Society (INBS), the combination of which is now the Irish Bank Resolution Corporation (IBRC). 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. Looking at the balance sheet of the IBRC, the funds from the promissory notes are needed to pay off Emergency Lending Assistance (ELA) from the Irish central bank, for which they have also been used as collateral. It was recently announced that, 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 will reduce the Irish funding needs this year. Also, it is 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 successful restructuring will be beneficial both to Irish debt sustainability and to popular support for the government.

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Ireland

Selection of economic indicators	2007	2008	2009	2010	2011	2012e	2013f
Key country risk indicators							
GDP (% real change pa)	5.2	-3.0	-7.0	-0.4	0.7	-1.0	0.5
Consumer prices (average % change pa)	4.9	4.0	-4.5	-0.9	2.6	1.8	1.5
Current account balance (% of GDP)	-5.3	-5.7	-2.9	0.5	0.3	0.8	0.1
Economic growth							
GDP (% real change pa)	5.2	-3.0	-7.0	-0.4	0.7	-1.0	0.5
Gross fixed investment (% real change pa)	2.1	-10.4	-28.7	-25.0	-16.0	-10.0	-2.0
Private consumption (real % change pa)	6.5	-1.0	-7.0	-0.7	-3.2	-3.0	-1.0
Government consumption (% real change pa)	6.7	0.5	-4.5	-3.9	-3.7	-3.0	-2.0
Exports of G&S (% real change pa)	8.4	-1.1	-4.2	6.3	4.8	1.6	1.8
Imports of G&S (% real change pa)	8.0	-2.9	-9.3	2.7	-0.3	-1.3	0.4
Economic policy							
Budget balance (% of GDP)	0.1	-7.3	-14.2	-31.3	-10.1	-8.8	-8.4
Public debt (% of GDP)	25	44	65	105	115	122	98
Money market interest rate (%)	4.3	4.6	1.2	0.8	1.4	1.0	0.8
M2 growth (% change pa)	6	-1	6	-8	-3	2	2
Consumer prices (average % change pa)	4.9	4.0	-4.5	-0.9	2.6	1.8	1.5
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	14.7	15.0
Balance of payments (mln USD)							
Current account balance	-13876	-14955	-6544	1010	700	1700	200
Trade balance	27154	35015	45235	48423	50400	46700	43500
Export value of goods	115241	119173	108180	110051	120600	113900	112900
Import value of goods	88088	84158	62945	61628	70220	67230	69480
Services balance	-1536	-11280	-11219	-9412	-9300	-10200	-8800
Income balance	-38138	-36993	-38880	-36374	-38700	-33200	-32900
Transfer balance	-1357	-1697	-1682	-1621	-1700	-1600	-1600
Net direct investment flows	4014	-34906	-285	8979	18580	9600	6330
External position (mln USD)							
International investment position	-54360	-178940	-227500	-200660	n.a	n.a	n.a
Total assets	3341750	3039730	3316540	3332300	n.a	n.a	n.a
Total liabilities	3396110	3218670	3544040	3532960	n.a	n.a	n.a
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	10.4	13.2	20.2	23.4	23.1	23.2	21.9
Current account balance (% of GDP)	-5.3	-5.7	-2.9	0.5	0.3	0.8	0.1
Inward FDI (% of GDP)	9.4	-6.2	11.9	13.1	17.8	16.2	16.1
International investment position (% of GDP)	-20.9	-67.6	-101.7	-96.9	n.a	n.a	n.a

Source: EIU

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