

Ireland

Ireland – After the Programme

- Ireland's now-completed 3-year programme is generally viewed by investors and officials as a clear success story among the euro area crisis countries. And, to be sure, Ireland fully met the Troika's specific targets in terms of fiscal measures, the fiscal deficit and reform measures.
- Even so, in our view, the notion that Ireland's programme counts as a success must be heavily qualified. Unlike many countries that have been under IMF programmes, Ireland's joint IMF/EU programme did not aim to cut Ireland's debt/GDP ratio or to leave it on a clear downtrend. No country in recent years has successfully exited an IMF programme with as high a public debt ratio as Ireland. Ireland's general government gross debt/GDP ratio has risen by nearly 100% of GDP in the last six years, the biggest rise for any advanced economy in recent decades.
- Having left the EU/IMF programme with among the world's highest public debt burdens, Ireland's path back to fiscal sustainability rests on a sustained pickup in real and nominal growth post-programme, plus continued modest nominal interest rates on government debt. Recent weakness in industrial production and exports suggest Ireland's growth slowed in Q4, and we cannot rule out a small decline in Q4 GDP. Nevertheless, the underlying path of the economy seems to be improving, with solid trends in business surveys, house prices and employment. Real GDP growth is likely to rise to 2-2½% this year and in 2015, outperforming the euro area average but – with low capital stock growth and the overhang of high household debt – markedly below Ireland's stellar pre-crisis trend. With low inflation, nominal GDP growth this year probably will be only about 3% YoY.
- Such a pace of real and nominal growth probably will be enough to get the government debt/GDP ratio falling slightly this year (especially if, in line with the Budget plans, the authorities partly finance this year's fiscal deficit by running down their cash reserves, rather than new debt issuance). But if nominal GDP growth stays around 3% YoY, then the public debt ratio would fall only slowly in later years and overshoot official forecasts. Moreover, the economy's prospects in coming years – and hence Ireland's ability to return to fiscal sustainability -- are vulnerable to external shocks and currency swings. If the recovery is blown off course by external shocks (and this is not our base case) or if the ECB allows the euro area to lapse into persistent very low inflation, then prospects for Ireland's debt/GDP ratio in coming years could again worsen markedly.

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Ireland – After the Programme

Ireland's Programme -- A Qualified Success

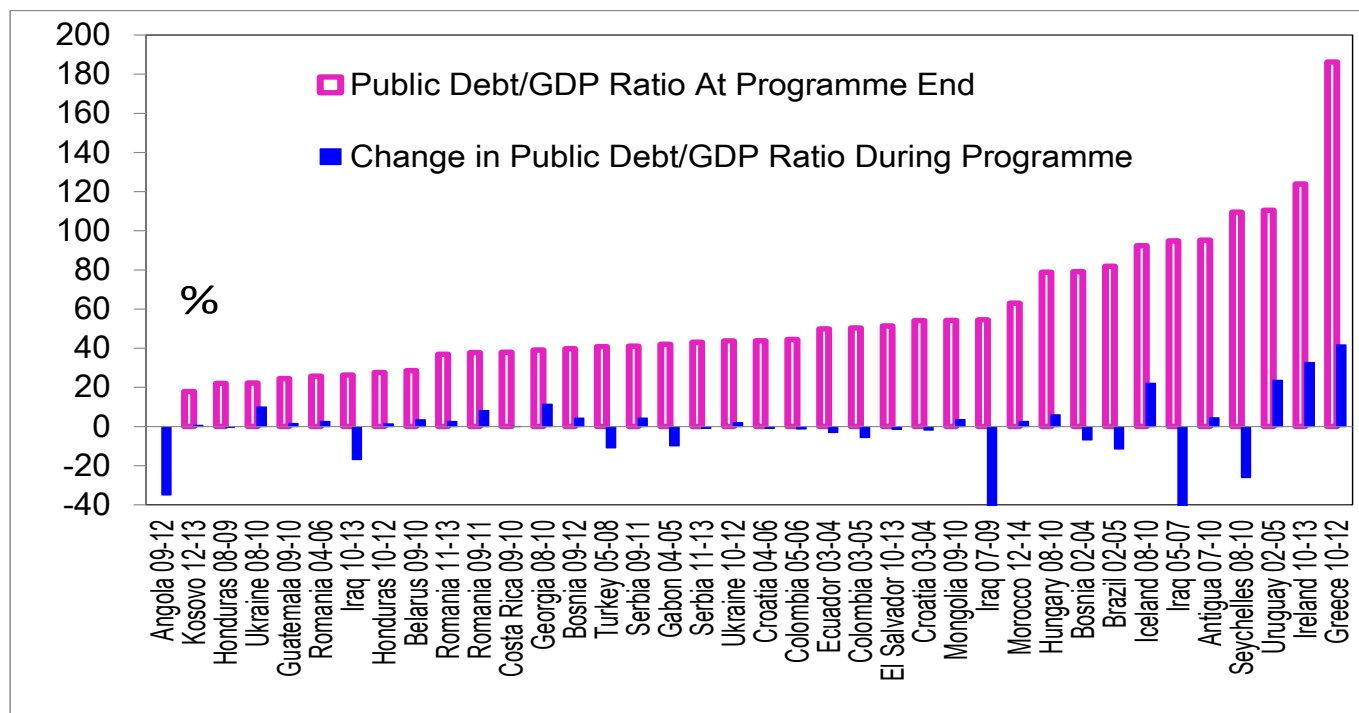
Ireland has successfully exited its EU/IMF programme...

Ireland's now-completed 3-year programme is generally viewed as a clear success story among the euro area crisis countries. And, to be sure, Ireland fully met the Troika's specific targets in terms of fiscal measures, the fiscal deficit and reform measures. Bond yields have fallen sharply, the economy has returned to growth in recent quarters and the government has already raised enough finance to fully cover the expected 2014 fiscal deficit.

...but Ireland has exited its programme with a high fiscal deficit and having experienced a sharp rise in the public debt/GDP ratio over recent years

Even so, in our view, the notion that Ireland's programme counts as a success must be heavily qualified. The cyclically adjusted fiscal deficit in 2013 was about 6½% of GDP, second only to Greece among EMU countries (excluding bank recap costs). Moreover, unlike many countries that have been under IMF programmes, Ireland's joint IMF/EU programme did not aim to cut Ireland's debt/GDP ratio or to leave it on a clear downtrend. Ireland's public debt/GDP ratio reached 124.8% of GDP in Q3-13 (Eurostat data), up from 117.1% of GDP a year earlier and 91% of GDP at end-2010 (when the programme began). The rise in Ireland's debt ratio, of more than 30pp of GDP, is in line with the original 2010 bailout plan (which forecast the debt ratio at 124.5% at end-2013). In all, there have been 38 IMF rescue programmes (excluding concessional programmes for low-income countries) that have been launched and completed since the start of 2002, and for which public debt data are available. Of these, only the ill-fated first Greece programme (originally scheduled for 2010-13, but curtailed in 2012) ended with a higher public debt/GDP ratio at the end of the programme (before restructuring) -- and a bigger rise in the debt/GDP ratio during the programme -- than Ireland's recent programme. At the end of all the other programmes, the countries concerned had a lower debt ratio than Ireland now. Several other countries started IMF programmes with higher public debt ratios than Ireland but, by a mix of debt restructuring and/or inflation, cut their public debt ratios during the IMF programme.

Figure 1. Selected Countries – Public Debt/GDP Ratio at Completion of IMF Rescue Programmes, 2002-14



Sources: IMF and Citi Research

The sharp rise in Ireland's debt/GDP ratio during its programme chiefly reflects low nominal GDP growth and the limited extent of restructuring of public liabilities

Note that on the IMF's current forecasts, Portugal and Cyprus will both complete their ongoing programmes with a public debt/GDP ratio that is close to Ireland's, but having had a smaller rise in this ratio during the programme. The fact that Ireland's debt ratio has risen markedly during its IMF programme can, in turn, be traced chiefly to the limited extent of debt restructuring of government liabilities¹ and low nominal GDP growth – hitting revenues and lifting the public debt/GDP ratio via the “denominator effect”. Ireland's nominal GDP rose by about 4½% in total from 2010-13, the lowest during any IMF programme since 2002 (apart from Greece's 2010-12 programme, which saw an outright decline in nominal GDP).

Ireland's government debt ratio is now among the world's highest

In all, including bank recap costs, Ireland's public debt/GDP ratio has risen by 98 percentage points over the last six years (from 25% at end-07 to about 124% at end-13), the biggest rise of any country in that period². Indeed, no other advanced economy has had such a sharp rise in its public debt/GDP ratio over a five-year period at any time in the last 30 years³. The only countries to have seen a larger 5-year rise in the public debt/GDP ratio over the last 30 years have been Argentina (rise of 104pp over 1998-2003) and the Republic of Congo (rise of 135pp over 1993-98), with a similar rise in Algeria (98pp of GDP over 1991-96). In 2006, Ireland's debt/GDP ratio was in the bottom quartile of countries around the world: now it is the eighth highest, exceeded only by Eritrea, Greece, Italy, Jamaica, Japan, and Portugal⁴.

So we regard Ireland's programme as only a qualified success...

So, while Ireland has succeeded in meeting its fiscal targets, we do not regard those targets as unambiguously clear milestones to fiscal sustainability.

...in that domestic and external actions have helped Ireland exit with low borrowing costs

In our view, the key achievement of Ireland's programme has been to buy time for three key developments which have helped calm markets: (1) periphery countries, including Ireland, have implemented considerable fiscal austerity without (so far) a major swing to anti-EMU political parties; (2) the ECB, via liquidity provision and the OMT programme, helped backstop sovereign spreads (possibly helped also indirectly by the Fed's QE programme); (3) EU creditor nations retreated from prior hints of possible EMU exit and/or sovereign debt haircuts for weaker countries, and emphasised their intention to preserve EMU and move towards closer integration (eg through banking union, even if this may be more limited than initially hoped). Hence, while Ireland has emerged from its programme with a relatively high deficit and debt/GDP ratio, it has (like other periphery EMU countries) got relatively low sovereign yields.

Higher Nominal GDP Growth Crucial for Fiscal Sustainability

Ireland's debt/GDP ratio may well fall this year...

There is a good chance that Ireland's gross public debt/GDP ratio will fall in 2014. The authorities over-funded in 2013 (accumulating cash reserves) and have stated their intention to partly finance this year's deficit by running down cash reserves built up in 2012-13, thereby keeping the rise in gross public debt well below the fiscal deficit. Our base case is that the improvement in nominal GDP growth to about 3.0% YoY in 2014 from 0.7% in 2013 (helped by a reduced effect from the “patent cliff”) and fiscal tightening will cut the public debt/GDP ratio to 121.4% of

¹ Limited only to interest rate reduction and maturity extension on officially-held debt.

² The ratio of net public debt./GDP has risen by about 95pp, from 11% to 106% using IMF data. This is the biggest rise for any country for which data are available.

³ Note that this measure is for general government gross debt only. It does not include financial assets, or the debts and assets of NAMA.

⁴ Ireland's debt/GNP ratio was about 149% at end-2013. Only two countries, Japan and Greece, have a debt/GDP ratio above 149%.

...but prospects for a sustained drop in the public debt/GDP ratio rest on faster nominal GDP growth and low borrowing costs

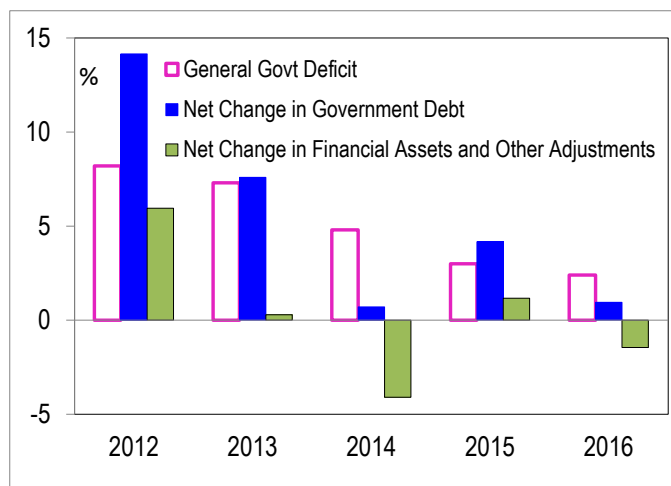
Even modest variations in the pace of nominal GDP growth in coming years could produce widely varying paths for Ireland's public debt/GDP ratio

GDP this year, slightly below last year's outturn (roughly 124% of GDP) and the first drop in Ireland's general government gross debt/GDP ratio since 2006.

However, Ireland's route back to fiscal sustainability is still not certain. Having exited the EU/IMF programme with a high debt ratio and only limited debt restructuring, Ireland's ability to achieve a falling debt ratio rests on a sustained period of low public sector borrowing costs, plus a sustained pick up in real and nominal GDP growth -- both to lift tax revenues (and hence cut the deficit) and also to pull down the debt ratio through the "denominator effect".

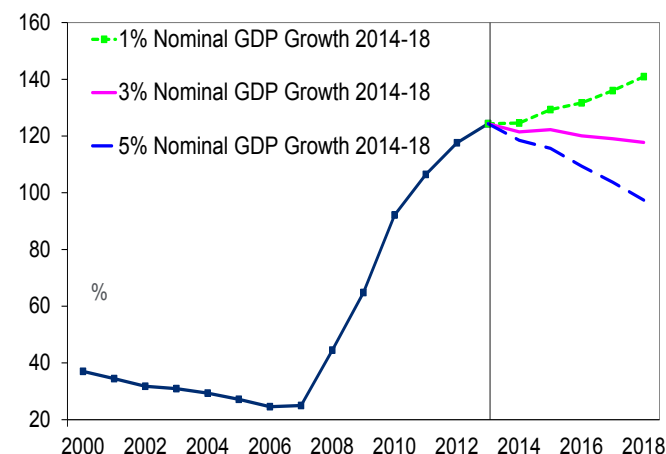
To illustrate this, Figure 3 shows scenarios for the public debt/GDP ratio using alternative paths for nominal GDP growth in 2014-18 of 1% YoY, 3% YoY and 5% YoY. The scenarios all assume that revenue/GDP ratio, and nominal public spending ex interest payments in cash terms, both match the IMF's forecasts, with any undershoot/overshoot in the fiscal deficit funded at a 3% marginal borrowing cost. With these assumptions, the breakeven pace of nominal GDP growth (ie the pace that stabilizes the debt/GDP ratio over the whole period 2014-18), is about 2½% YoY. Nominal GDP growth of 2.3% YoY (the pace seen in Q3-13) would bring the debt/GDP ratio a little lower in 2014 (thanks to the use of cash reserves), but this ratio would then rise in subsequent years, reaching about 126% (and rising) in 2018. Indeed, if nominal GDP growth slips to 1% YoY in 2014-18, the debt/GDP ratio will surge above 141% in 2018 -- and still be rising rapidly. Conversely, 5% nominal GDP growth would put this ratio below 100% (and falling rapidly) in 2018.

Figure 2. Ireland – Fiscal Deficit and Change in Govt Debt, Pct of GDP, 2012-15F



F Govt forecast. Sources: Finance Ministry, Eurostat and Citi Research

Figure 3. Ireland – Simulations for General Government Gross Debt/GDP Ratio With Varying Paths for Nominal GDP, 2000-18



Note: Simulations assume tax/GDP ratio and nominal primary spending match the IMF forecast, and that the marginal cost of extra debt is 3%. Sources: IMF and Citi Research

The breakeven pace of nominal growth needed to achieve a sustained drop in the public debt/GDP ratio is about 2½% YoY

Of course, these scenarios simplify. For example, they do not take any account of possible corrective fiscal actions if the deficit overshoots. Also, weakness in real and nominal growth might well cause revenues to undershoot disproportionately because of adverse cyclical effects. Moreover, a weaker economy might produce extra bank recapitalization needs or undermine plans for NAMA asset sales. But, our key point is that if Ireland achieves a lower debt ratio this year (by running down cash reserves), this does not guarantee it will continue to do so in coming years. There is little scope to prudently run down cash reserves further in later years. Hopes for a falling debt/GDP ratio in coming years rely on a sustained pickup in real and nominal economic growth.

There are still uncertainties over the scale of potential bank losses

Indeed, even if the economy picks up, structural weaknesses in the banking system probably will persist, with continued growth in NPLs and mortgage arrears. The rise in mortgage arrears is slowing, but the share of mortgages (on principal dwelling houses) at least 90 days in arrears hit 12.9% in Sep-13 (amounting to 17.4% of PDH mortgages measured by value) versus 11.9% at end-2012. A further 21% of BTL mortgages are at least 90 days in arrears. The change in the personal insolvency law late 2012 will probably lead to more losses shifting from households to banks. The level of NPLs (net of provisions) among the major banks rose to 135.5% of equity at the major banks in mid-2013 from 104.7% at mid-2012. The need to inject extra capital into the banks played a major role in Ireland's decision to seek a rescue programme, and – until there is greater clarity of the eventual peak in NPLs and mortgage arrears, risks that banks will need further (probably relatively modest) capital cannot be discounted.

Softer Q4 GDP Likely, But Underlying Trends Improving

GDP growth probably slowed in Q4...

After strong gains in GDP in Q2 and Q3 2013 (both more than 1% QoQ), recent data suggest growth was only modest in Q4 (we expect 0.4% QoQ, data due for release during March). There is a risk that a pullback in investment (which jumped 10.9% QoQ in Q3) could pull Q4 growth into negative territory. With the continued adverse effects of the "patent cliff", industrial production fell 2.1% QoQ in Q4 (with pharmaceuticals output down 7.5% QoQ). Q4 retail sales volumes slipped back 0.3% QoQ after the very strong gain (4.0% QoQ) in Q3, export volumes (goods) in Oct-Nov were 3.6% below the Q3 average, and credit is still shrinking.

...but the underlying trend in the economy does seem to be improving...

Nevertheless, abstracting from the patent cliff and short-term data volatility, the economy does seem to be picking up. The PMI surveys remain buoyant, job growth reached 3.3% YoY in Q4 (1.9% YoY excluding agriculture, forestry and fishing, a sector for which measured job growth may be affected by the introduction of the sample based on the 2011 Census), house prices in January rose 6.3% YoY and the jobless rate has fallen to 12.1% in Q4 (from 14.2% a year earlier).

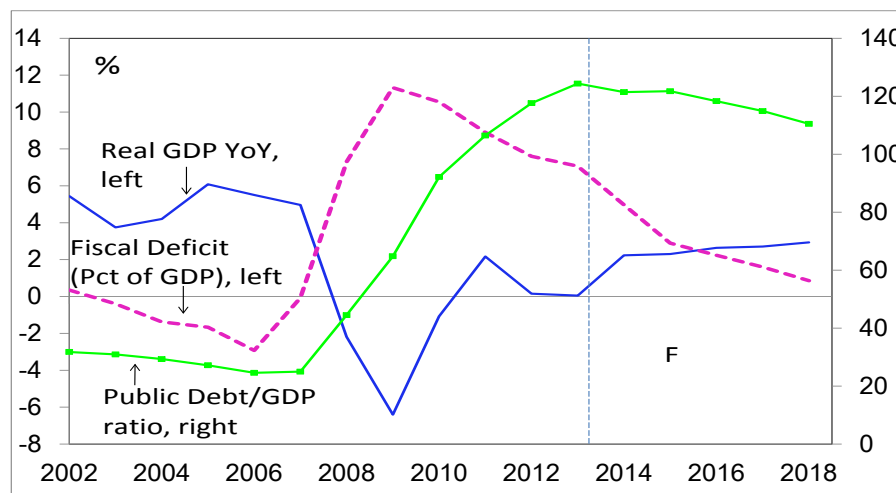
...in terms of both real and nominal GDP growth

Even so, real GDP growth in 2014-15 is likely to be modest rather than stellar. We expect growth of about 2.2% YoY in 2014, and a similar pace (2.3%) in 2015, well above our forecasts for the EMU average (1.1% in 2014, 1.3% in 2015), but far below the average of 1999-07 (6.3% YoY). Nominal GDP growth in Q3-13 was just 2.2% YoY. Inflation is close to zero at present, with the GDP deflator up by just 0.6% YoY in Q3-13 and the CPI up by just 0.6% YoY in Jan-14. With sizeable spare capacity still remaining, and weak wage growth, Ireland is likely to stay on the edge of deflation in 2014-15. As a result, trends in nominal GDP growth are likely to be only marginally faster than real GDP growth, at about 3% YoY in 2014-15.

Our base case is for a further drop in the public debt/GDP ratio in later years, but this forecast could be blown off course by external events

Our base case for later years is that nominal GDP growth will rise to an average of 3½%-4% YoY in 2014-18, hence cutting the public debt ratio to about 118% of GDP in 2016 and 110% of GDP in 2018. Our forecast is close to the forecasts of the Finance Ministry (debt/GDP ratio at 114.6% of GDP in 2016) and IMF (debt ratio at 112% of GDP in 2018). This path would at least establish a clear downward trajectory. However, it will leave Ireland's debt/GDP ratio far above pre-crisis levels (this ratio was 25% of GDP in 2007). Moreover, with Ireland's high level of openness, this fiscal path is acutely sensitive to external growth prospects and currency swings. Even with cautious domestic fiscal policy, Ireland's fiscal outlook could be blown off course by external shocks, for example in emerging markets, the EMU periphery or other advanced economies. Ireland's fiscal fate is, to a considerable extent, out of its own hands.

Figure 4. Ireland – GDP Growth, Fiscal Deficit, and Public Debt/GDP Ratio, 2002-18F



F Citi forecast. Sources: CSO, Finance Ministry, Eurostat and Citi Research

Ireland still has sizeable supply-side advantages, but the key drivers of Ireland's precrisis boom – rapid growth in TFP, capital stock and leverage – have all stalled

TFP growth has been negative on average in the last 10 years...

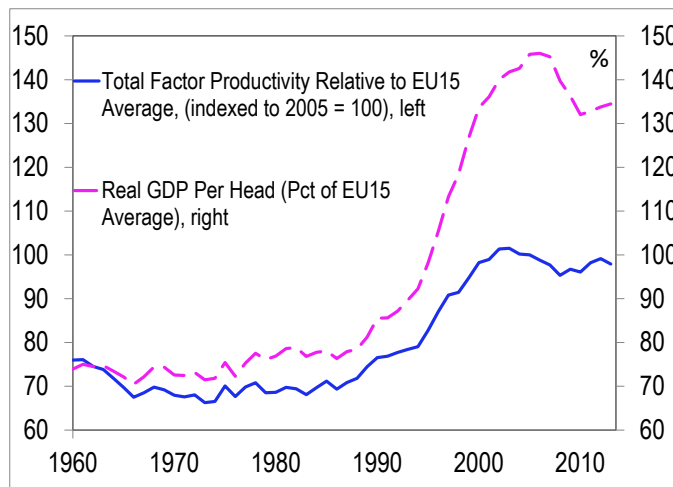
...while capital stock growth is close to zero...

Household debt remains elevated relative to income

To be sure, Ireland has sizeable economic advantages of supply-side flexibility, low corporate tax rates, high inward FDI and – since exports equal about 107% of GDP – the ability to generate positive growth in GDP and jobs even if domestic demand remains depressed. Moreover, even with the euro's resilience versus the USD, Ireland's real exchange rate (measured as relative unit labour costs expressed in a common currency) is 15% below the 2005-09 average, reflecting weakness in Ireland's labour costs and the recent appreciation of sterling (the UK is a key trading partner). However, the key drivers of Ireland's rapid growth from 1980-2006 -- rapid capital stock growth, rapid growth in total factor productivity (TFP, ie the efficiency with which resources are used) and leverage – have stalled in recent years.

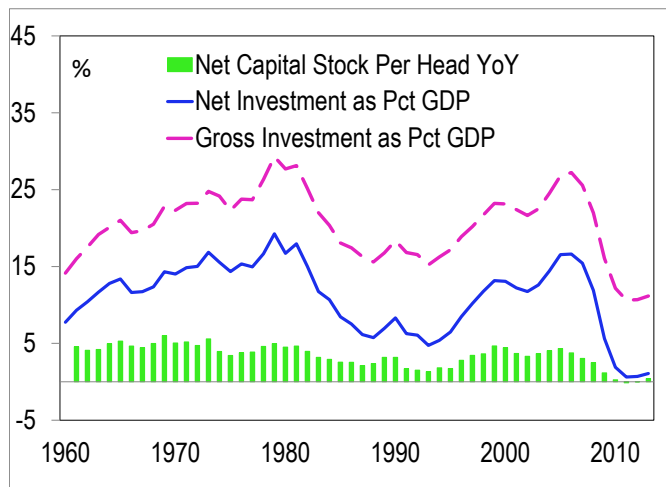
- As the economy opened up and modernized after EU entry in 1973, Ireland's TFP rose by an average of 3.3% YoY during 1986-2002 (inclusive), by far the highest of any advanced economy and a pace exceeded by only a few emerging markets. However, the TFP surge stalled many years ago. Since 2003, however, TFP on average has been slightly negative (down 0.3% YoY), a little below the EU average (growth of just 0.2% YoY).
- With rapid investment growth, Ireland's net capital stock per head (constant prices) rose from 75% of the EU15 average in 1960, to 120% in 2000 and 139% in 2009 – the highest in the EU apart from Luxembourg. However, with investment down to just 10.5% of GDP in Q1-Q3 2013 (record low), Ireland's net investment and capital stock growth are both close to zero.
- The ratio of household debt/income surged from 117% at end-2002 to 206% in mid-07 and (as incomes fell) the eventual peak of 219% in Q2-2011. The rise in household debt in the boom, relative to GDP, was among the biggest in any country over recent decades. The household debt/income ratio has since fallen back to 202% in Q3-2013. But this ratio is still similar to the levels of end-2006 and early 2007 -- at the very peak of the boom -- and far above historic norms. Ireland's household debt/income ratio also remains well above levels in the other countries which experienced major housing boom-bust cycles (eg this ratio is 103% in Spain, 105% in the US, 141% in the UK, 164% in Sweden). We suspect that the emphasis on balance sheet repair is not over.

Figure 5. Ireland – Total Factor Productivity and Real GDP Per Head Relative to EU15 Average, 1960-2013



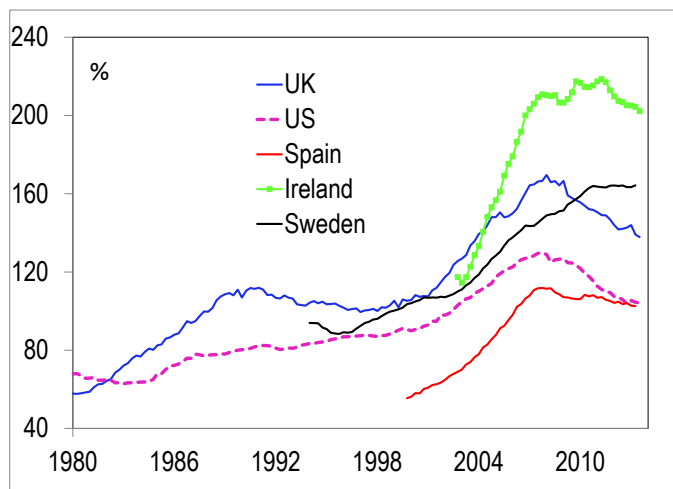
Sources: European Commission, Conference Board and Citi Research

Figure 6. Ireland – Investment as Pct of GDP and Capital Stock Growth, 1960-2013



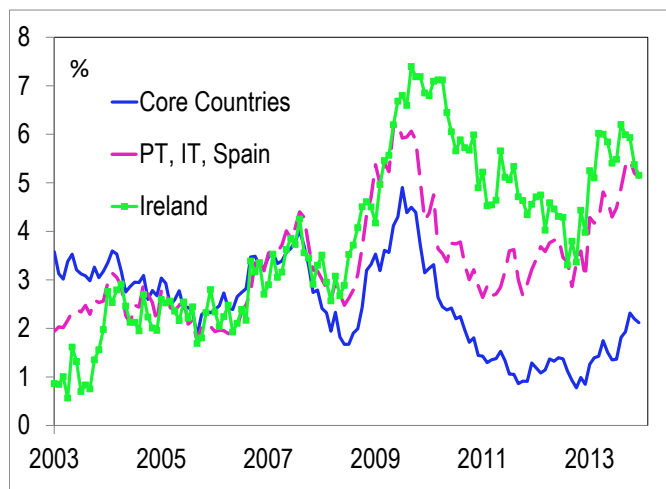
Note: Gross investment in 2013 is the average for Q1-Q3 only.
Sources: European Commission, CSO and Citi Research

Figure 7. Ireland, US, UK, Sweden, Spain – Household Debt/Income Ratio, 1980-2013



Sources: ONS, CSO, DataStream and Citi Research

Figure 8. EMU Countries – Real Interest Rates on Bank Loans up to €1m (Over One Year Maturity) to Businesses, 2003-13



Note: Real interest rates deflated by CPI inflation. The core is the unweighted average for Austria, Belgium, France, Finland, Germany and the Netherlands.
Sources: ECB, Eurostat and Citi Research

The economy also faces headwinds from fiscal policy and poor credit availability

Moreover, the economy faces extra headwinds from tight fiscal policy and poor credit availability. The EC judges that the structural fiscal stance will tighten by about 1½% of GDP this year, similar to that in 2013 (1.3% of GDP), with some further tightening likely in later years. The emphasis is on a further squeeze on government spending, which usually has quite direct adverse effects on GDP growth. With worries about credit quality, the average interest rate on new business loans up to €1m charged by banks in Ireland is 5.4% hence, with inflation (measured by the GDP deflator or CPI) close to zero, implying very high real rates of above 5%. Real rates on small-size business loans are more than twice the precrisis (2003-07) average, and far above levels in Germany (1.5%) and France (2.5%). Unsurprisingly, credit growth remains deeply negative, with loans to non-

financial companies down by 5.8% YoY in Jan-14 and loans to households down 4.1% YoY. Both are among the weakest across euro area countries. The poor availability and high cost of credit – and reduced competition among lenders -- may not be such a problem for Ireland's large stock of inward FDI, but probably does hurt the SME sector.

Ireland's supply side advantages are likely to be reflected in a high GDP level but not necessarily high GDP growth

In these circumstances, we suspect that Ireland's supply-side advantages will allow the country to maintain a relatively high level of GDP per head and to grow slightly faster than most other EU countries, but not outperform sharply in growth terms. Back in 1986, Ireland's real GDP per head (at constant prices) was only 76% of the EU15 average. By 2005-06, Ireland's GDP per head had risen to 146% of the EU15 average, and among EU countries was second only to Luxemburg. Since then, Ireland's real GDP per head has slipped to 134% of the EU15 average – still among the EU's highest but (even with the country's supply-side advantages) no longer outperforming.

Ireland's route back to fiscal sustainability remains uncertain and vulnerable to shocks

Uncertainties over Ireland's route back to fiscal sustainability would be greatly increased if (as the government has sought to achieve) the bank recap costs of recent years could be shifted off the central government's balance sheet. However, the likelihood of that has fallen in recent quarters with the banking union discussion and strict conditionality on direct bank recaps. The emphasis in future euro area bank bailouts is firmly on exposing some bank creditors to losses, and then putting any recap burden on national governments, rather than any joint pooling of recap costs. As a result, Ireland's route back to fiscal sustainability – though better than seemed likely a year or two ago – remains by no means secure. Moreover, in the event that EMU strains do re-intensify, for whatever reason, doubts over the legality of the OMT and the political difficulties of getting ESM programmes ratified means that policymakers would find it difficult to respond at the likely speed of events.

Appendix A-1

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