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Analysis

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Ireland

Macroeconomic performance

For nearly a decade the Irish economy has been characterised by high growth rates which, supported by a favourable demographic profile and outward oriented policies, contributed to a substantial rise in wealth levels. Moreover, structural changes that have taken place since the 1980s in the context of Ireland's membership in the European Union (and now EMU) have made the economy much more resilient, flexible and better able to sustain shocks. Strong investment spending and foreign direct investment (FDI) remain catalysts for the economy's capacity to generate growth and income.

GDP growth levels back at sustainable levels, but some inflation risks remain

GDP growth rates slowed down substantially between 2001 and 2003 from levels near 10% the years before. The most important external factor for this trend has been the US economic downturn, due to Ireland's strong export and FDI links with the US. For 2004 and 2005 a substantial economic recovery can be expected, mainly driven by international trade and increasing consumer confidence, pushing GDP growth rates to around 5%. Although consumer confidence can not be expected to reach former top levels, it is worthwhile to stress that the economy continues to benefit from a relatively young and increasing population, also due to immigration. Supply of foreign labor force has further increased after EU enlargement, helping to limit ongoing tightness on the labor market and to support (wage) discipline. Inflation seems to continue its converging downward trend towards the Eurozone average of around 2%. There is a risk of some inflationary pressure building up in an environment of already substantial capacity utilisation and government expenditure increase. Furthermore, bottlenecks in infrastructure, housing, skilled labour supply and transport may constrain future growth and represent a probable source of inflationary pressure.

Gradual slowdown of house prices, but Irish borrowers remain vulnerable to shocks

Another risk factor is housing price inflation. House prices continued to increase in double digit figures on the back of interest rate driven strong demand. There are first indications of a gradual slowdown in house prices. Ireland enjoys one of the lowest interest rate levels for housing finance which has helped to stabilise the overall debt service burden. Household credit as a proportion of personal disposable income has risen from 43% in 1993 to 95% in 2003, a clear consequence of EU convergence to low interest rates. However, Irish households are not an outlier in this, with comparable developments in other former high yield countries, like Portugal or Spain. The high proportion of variable rate mortgages leaves Irish borrowers exposed to an increase in interest rates and enhances their vulnerability to income and employment shocks in the medium term.

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FDI inflows help to keep economic growth potential high

A soon return to an overheating economy seems unlikely, also because the end of extraordinarily high employment growth should contribute to a more sustainable GDP growth pattern in the medium-term. An ongoing solid volume of FDI inflows helps to keep a high growth potential of an economy which faces the challenge to move further on the value-added chain. Former very high FDI inflows, which have helped in the past to catch up with productivity of main competitors, are irrealistic today and would be difficult to absorb, due to labor market tightness. On the other hand, CEE countries do not seem able so far to detract those FDI flows away from Ireland. Foreign companies continue to value the business-friendly regulatory environment, low taxation, highly educated workforce and efficient co-operation with Irish authorities.

Wage inflation remains a risk for international cost competitiveness

National wage agreements between government, trade unions and business leaders have not prevented wage inflation from moving significantly higher than in the country's main trading partners. The resultant loss in cost competitiveness seems to have been more than balanced in the past by strong productivity growth in the tradeable goods sector, thanks to large FDI inflows in high-technology sectors. However, output figures tend to overstate productivity because of tax-induced temporary profit transfers to Ireland of multinationals. Therefore, a relatively high differential in average hourly earnings remains a risk factor for the economy's cost competitiveness, even though a more moderate outlook for consumer price inflation should support moderation in wage demand.

Political/Social Developments

Government health care costs are rising markedly

Despite considerable expenditures over the last decade, the quality of public services, especially in health care and education, and the state of infrastructure are perceived as insufficient and will necessitate further investments by the government. The health sector faces a value-for-money problem: government health care costs are rising markedly, with large staff increases but only moderate efficiency gains, especially in the hospitals sector. The establishment of a Commission on Financial Management and Control Systems in the Health Service in 2002 is an important step towards better budgetary control. The approved merger of the current eleven health authorities into one major national health agency (Health Services Executive) seems appropriate to re-organize the system, clearly assign responsibilities and raise cost efficiency.

Authorities seek to secure long-term sustainability of the pension system

Concerning the long-term pension issue, Ireland is in a better position than most other Eurozone countries: its favourable demographic situation does not only continue to support growth but is also limiting financial obligations to the welfare system. The declining dependency ratio (the number of those under 15 and over 65 years old as a share of the total population) alleviates pressures on public finances and on future pension obligations. However, to enhance long-term sustainability of public finances, the government aims at increasing the effective retirement age in the public sector by installing a more restrictive approach to early retirement. Ireland benefits from a developed second pillar of corporate and private pension schemes. Personal pension savings schemes can be moved between different employers and provide further support, as do special savings incentives for younger people. Moreover, the government is setting aside budget revenues in a National Pensions Reserve Fund, equal to 1% of GNP per year. These annual transfers and planned contingency reserves against unforeseen developments represent important factors of long-term sustainability.

Government Finance and Debt

General government budget: reduction of surpluses has cyclical and structural reasons

After an extraordinary surplus of 4.4% of GDP in 2000 the general government budget posted a slight surplus in 2001 and a roughly balanced position since then. Part of this surplus meltdown can be attributed to slower revenue growth in line with the economic downturn at that time. Some revenue under-performance was also due to lower structural revenue growth, as a result of income tax cuts and tax credits. In the 2003 budget, various revenue-raising measures such as increases in indirect taxes and user charges were introduced. Measures to increase tax discipline have helped to support tax revenues above target since then. Revenues seem to come in above target also in 2004. Although this development is to a good part due to one-off factors (special tax investigations and high revenues from capital gains tax), it also points to an underlying economic recovery.

The way from former general government budget surpluses to roughly balanced budgets also mirrors new priorities on the expenditure side. Government spending increased substantially on health care, education and social welfare. Furthermore, the government intensified investment into infrastructure and the quality of public services. The government remains committed to the investment spending plans of the National Development Plan, with continuously strong investment spending into infrastructure and capital investment at 5% of GNP until 2008.

Authorities likely to continue prudent policies, even though new priorities arise

The fact that people continue to complain about problems with infrastructure and (timely) access to (emergency) healthcare services indicates that further reforms are necessary to guarantee more efficient services. Under a new Finance Minister it seems likely that the government will use the increased (cyclical) scope of fiscal revenues to further improve public services. However, Moody's also expects that the government will continue with prudent fiscal management, taking into account that medium-term economic growth will probably turn out to be more moderate and sustainable than exceptionally high growth rates of the 1990s. Close monitoring of current spending and ministries' responsibility to respect agreed budget limits act as a factor of discipline. It also seems that recent restrictions of public sector recruitment are largely maintained with the effect of lowering government expenditures. All in all, Moody's notes that the Irish government's fiscal position remains sound. The fiscal consolidation process continues to favour the downward trend in general government debt as a percentage of nominal GDP, now close to the 30% level.

International Investment Position and Banking Sector

Supervision of the Ireland's banking sector has been enhanced by the unification of supervision under the Irish Financial Services Regulation Authority within the Central Bank (Central Bank and Financial Services Authority of Ireland Act, 2003). High levels of capitalization and profitability seem to have strengthened the Irish banks' capacity to weather potential macroeconomic shocks without systemic distress. Irish banking institutions currently operate in a less dynamic but more sustainable economic growth environment than during the 1990s. Nevertheless, profitability remains robust, despite the overall contraction in net interest margins and upward wage pressure. Asset quality remains sound, reflected by low arrears levels. The fact that a significant proportion of banks' lending portfolios are secured against residential mortgages mitigates risks generally. The shock absorption capacity of the banking system seems adequate in the case of a sudden fall in residential property prices. However, whilst Moody's is not anticipating a significant increase in either unemployment or interest rates, a sharp rise in either would present a threat to the credit quality of mortgage lenders generally. Although Irish banking institutions derive considerable advantage from the availability of strong retail deposit bases, the fact that loan growth has been outstripping deposit growth places added pressure on banks' funding bases. Banks have been countering this pressure via the ongoing diversification of funding resources.

Ongoing FDI inflows reflect a strong interest by high-tech companies to research and produce in Ireland. Within EU-25 Ireland was the largest net recipient of FDI in 2003, followed by Germany. Outside EU-25 Ireland was the second largest net recipient of FDI.

Related Research

Banking System Outlook:

Banking System Outlook: Ireland, September 2004 (88823)

Special Comments:

Moody's Sovereign Ratings: A Ratings Guide, March 1999 (43788)

A Quantitative Model for Local Currency Government Bond Ratings, September 2003 (79404)

A Quantitative Model for Foreign Currency Government Bond Ratings, February 2004 (81176)

Has Fiscal Consolidation Stopped in Europe?, October 2002 (76312)

Rating Methodology:

Revised Country Ceiling Policy, June 2001 (67679)

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

Ireland

Main Economic Indicators	1997	1998	1999	2000	2001	2002	2003E	2004F	2005F
Real GDP (%y/y)	11.1	8.6	11.3	10.1	6.2	6.9	3.7	5.2	5.4
Private Consumption (%y/y)	7.3	7.3	9.6	8.5	5.5	2.8	2.6	3.8	4.5
Public Consumption (%y/y)	5.0	5.6	7.7	7.6	11.6	8.6	2.5	2.2	3.5
Gross Fixed Investment (%y/y)	18.9	14.9	14.0	7.1	0.2	3.0	3.4	8.2	5.3
Domestic Demand (%y/y)	11.8	8.8	7.5	9.1	3.8	3.4	3.3	4.2	7.2
Contribution to GDP Growth									
Net Exports	2.5	-0.5	4.3	2.3	2.9	4.6	1.1	1.7	1.3
Domestic Demand	9.9	7.2	7.9	7.3	3.7	2.7	2.3	3.6	4.1
Stockbuilding	0.6	0.6	-1.3	0.5	-0.4	-0.4	0.3	-0.1	0.0
Unemployment Rate (%)	9.9	7.5	5.6	4.3	3.9	4.4	4.6	4.4	4.3
GDP Deflator	4.0	6.3	3.8	4.3	5.1	5.4	1.9	1.9	2.5
CPI (harmonized index, %y/y)	1.2	2.1	2.5	5.2	4.0	4.7	4.3	2.6	2.3
Comparison: Prices in Eurozone									
CPI (harmonized index, %y/y)	1.7	1.2	1.1	2.1	2.4	2.3	2.1	1.8	1.6
Indicators of Competitiveness									
Output (% growth)	11.1	8.6	11.3	10.1	6.2	6.9	3.7	5.2	5.4
Employment (% growth)	4.0	8.4	6.5	5.1	2.8	1.9	1.9	2.3	1.8
Productivity (% growth)	7.1	1.9	4.8	5.0	3.4	5.0	1.8	2.9	3.6
Wages (per worker, manufact.,% growth)	4.2	5.2	5.2	8.1	9.0	5.5	5.4	5.0	4.2
Unit Labor Costs (manufact.,% growth)	-2.9	3.3	0.4	3.1	5.6	0.5	3.6	2.1	0.6
Comparison: Eurozone									
Output (% growth)	2.3	2.9	2.8	3.5	1.6	0.9	0.4	1.7	2.3
Employment (% growth)	0.9	1.9	2.2	2.4	1.5	0.6	0.2	0.5	1.0
Productivity (% growth)	1.4	1.0	0.6	1.1	0.1	0.3	0.2	1.2	1.3
Wages (% growth)	2.1	1.2	2.2	2.8	2.9	2.7	2.8	2.4	2.3
Unit Labor Costs (% growth)	0.7	0.2	1.6	1.7	2.8	2.4	2.6	1.2	1.0
Public Finances (% of GDP)									
General Government Balance	1.1	2.4	2.4	4.4	0.9	-0.2	0.1	0.3	0.1
Central Government				4.1	0.7	0.1	-0.5	-0.2	-0.2
Local Governments				0.1	-0.1	-0.1	0.4	0.2	0.0
Social Security Funds				0.4	0.4	-0.2	0.2	0.3	0.3
General Government Revenues/GDP	38.6	37.2	36.8	36.3	34.5	33.6	34.4	35.1	34.7
General Government Expenditures/GDP	37.5	34.9	34.5	31.9	33.5	33.8	34.3	34.8	34.6
Primary Expenditures	33.8	31.4	32.1	29.9	32.1	32.5	33.0	33.8	33.7
Interest Payments	3.7	3.5	2.4	2.0	1.4	1.3	1.3	1.0	0.9
Primary Balance	4.8	5.7	4.7	6.4	2.4	1.1	1.4	1.3	1.0
General Government Debt/GDP	61.3	54.9	48.6	38.3	35.9	32.7	32.1	30.3	29.1
External Accounts									
Total Exports (% volume growth)	17.4	21.0	15.2	20.6	8.3	6.9	-0.8	5.8	7.2
Total Imports (% volume growth)	16.8	25.5	12.1	21.3	6.5	4.1	-2.3	4.5	7.0
Current Account (% of GDP)	3.1	0.8	0.3	-0.4	-0.7	-1.3	-1.4	-1.3	-1.1

Rating History Ireland

	Foreign Currency Bonds and Notes		Foreign Currency Bank Deposits		Local Currency Government Bond	Date
	Long-term	**Short-term**	**Long-term**	**Short-term**		**Mm/dd/y**
Rating Assigned		P-1			P-1	12/4/86
Rating Assigned	Aa3		Aa3			7/15/87
Rating Assigned					Aaa	9/4/92
Rating Placed on Review for Possible Upgrade	Aa3		Aa3			6/4/94
Rating Upgraded	Aa2		Aa2			8/31/94
Rating Placed on Review for Possible Upgrade	Aa2		Aa2			1/24/97
Rating Placed on Review for Possible Downgrade					Aaa	1/25/97
Rating Upgraded	Aa1		Aa1			2/13/97
Rating Confirmed					Aaa	2/14/97
Rating Placed on Review for Possible Upgrade	Aa1		Aa1			3/18/98
Rating Upgraded	Aaa		Aaa		P-1	5/4/98

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