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Analysis

IRELAND
Europe/M.East/Africa

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Ireland

Macroeconomic performance

For over a decade the Irish economy has been characterized by high growth rates which, supported by a favorable 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 (Monetary) Union 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 back at sustainable levels…

GDP growth rates slowed down substantially between 2001 and 2003, after rates around 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. Economic recovery since 2004 is mainly driven by domestic demand and increasing consumer confidence, with real GDP growth back on track for rates above 5% since 2005. Demographics (young population), immigration and increasing labor market participation have led to increases in employment, average earnings, real disposable income and housing demand, thus continuing to be important drivers for GDP growth.

…but imbalances have increased

Compared to the 90s the Irish growth composition has become imbalanced with economic growth now being heavily based on domestic demand. For 2006 and 2007 this is expected to continue supported by the maturing of Special Savings Incentives Accounts (SSIA) which should provide a further impetus to private consumption with the main impact to be in 2007. Net export contribution has declined due to some sector-specific issues (chemicals and ICT), the general deterioration in cost competitiveness in recent years and the strong Irish domestic demand. Since the Irish economy is not as diversified as large economies it is therefore particularly exposed to external risks such as the unwinding of US imbalances which could lead to a Euro appreciation and dampen export growth.

…with the construction sector playing an exceptional role

The booming construction sector plays an exceptional role in the Irish economy, supporting growth and employment. It accounts for about 12.5% of total employment, which is far in excess of 8% recorded in the EU25. The building sector has also a strong impact on linked (services) sectors. This indicates to Moody's that a profound correction could have a major impact on the drivers of Irish GDP growth; however, for 2006/2007 the maturing of SSIA's should support home improvement investment and over the long term, huge infrastructure needs of the Irish economy may exert continuing demand for construction investment. Therefore, even in an environment with higher interest rates and less strong immigration inflows, the Irish construction sector may decline somewhat over the next few years but still remain strong as compared to other developed countries.

Housing boom seems fundamentally backed

Housing market developments in Ireland are a risk factor for the economy, and some correction may develop. However, in the first half of 2006 house prices continued to increase despite strong housing output and several interest rate hikes by the ECB. We think the relatively broad and sustainable basis for housing demand is set to continue, reflected by strong demographics, substantial real income development and ongoing catching up effects. Therefore, the housing boom seems fundamentally backed and does not seem to be just a function of historically low interest rates. Furthermore, Ireland's economic base has broadened and become more stable over the years, indicating substantial resources to cope with risk of correction. As an example, even though private households' accumulation of debt and hence debt service ratio is important, real income after debt service has risen substantially and no bad debts have been recorded. In addition, the ratio of household's net worth to personal disposable income has increased considerably over recent years due to strong investment growth in housing stock and rising house prices. Cyclically rising interest rates would imply a larger income basis and therefore do not pose a particular risk. An external interest rate shock would hit households' budget balance but does not seem likely in the medium term. Irish households are not an outlier in this kind of interest rate risk, with comparable developments in other former high yield countries, like Portugal or Spain.

FDI pivotal to keep economic growth potential high

FDI has been and remains very important for Ireland because 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. However, former very high FDI inflows, which have helped in the past to catch up with productivity of main competitors, are not any more realistic today and would be difficult to absorb, due to labor market tightness. The large decline in FDI inflows in 2004/2005 reflects primarily the redistribution of funds within multinational corporate structures such as loans between affiliates and a temporary repatriation of profits by US firms. Central and Eastern European countries do not seem able to detract FDI flows away from Ireland, which go mainly into typical Greenfield investments. In 2005, the Irish Industrial Development Agency (IDA) reported 71 new business projects, involving a total investment of more than 760 million Euros over the next years; 41 of these have been Greenfield investments.[1] Furthermore, foreign companies continue to value the business-friendly regulatory environment, low taxation, highly educated workforce and efficient co-operation with Irish authorities. Infrastructure bottlenecks are an issue, and authorities are seeking to remove them.

Widening inflation differential remains a risk for international cost competitiveness

After reaching convergence with the (harmonized) Eurozone inflation of around 2% in 2005, Irish inflation has started to increase again significantly in 2006. This reflects mainly domestic inflationary pressures, such as higher prices in the food sectors and a broad range of domestic services. The factors underlying rising services sector inflation mirror a combination of ongoing strong domestic demand conditions, rising production costs and a lack of competition in some sheltered sectors of the economy. Continuing high energy prices contributed more indirectly through higher input costs in the non-energy sector. Higher mortgage interest repayments for homeowners, which are not reflected in the harmonized inflation rate, increased the national inflation measure even more which is now expected to be close to 4% for 2006, significantly higher than that of the country's main trading partners. Together with continuing strong earnings growth due to the ongoing tightness on the labor market this results in a loss in cost competitiveness. In the past, this seems to have been more than offset by relative productivity gains in the tradable goods sector, thanks to large FDI inflows in high-technology sectors. However, output figures tend to overstate productivity because of temporary profit transfers to Ireland of multinationals. Furthermore, since the beginning of 2000 economy-wide relative unit wage costs (EC index) have increased strongly since productivity growth has not kept pace with wage increases, indicating a clear deterioration in the Irish cost competitiveness position with main trading partners. A new social part-

1. *For more detailed information, see "IDA Annual Report 2005", IDA at www.idaireland.com.*

nership agreement "Towards 2016", agreed between the government, trade unions and employers in June 2006, is intended to moderate wage growth in the future. It will result in a cumulative pay rise of 10% over 27 months.

Political/Social Developments

Public services face increasing costs and value-for-money problem

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 merger of the eleven health authorities into one major national health agency (Health Services Executive) seems appropriate to re-organize the system, to clearly assign responsibilities and to raise cost efficiency.

Authorities seek to further secure long-term sustainability of public finances

Concerning the long-term pension issue, Ireland is in a better position than most other Eurozone countries: its favorable demographic situation does not only continue to support growth but is also limiting financial obligations of the welfare system. The relatively less generous flat-rate pay-as-you-go pension alleviates pressures on public finances and on future pension obligations. In a recent report, the European Commission evaluated Ireland to be at medium risk with respect to long-term sustainability of public finances, projecting an increase of total age related costs of 7.8% of GDP to 2050 from a relatively low level of 15.5% of GDP in 2004.[2] However, the Pensions Board in its National Pensions Review raised a number of issues giving reason for concern, such as a significant increase predicted in the annual costs of social welfare retirement pensions and public service pensions due to population ageing and insufficient supplementary pension coverage.[3] As a reaction, the government plans to issue a Green Paper on pensions policy and to develop a comprehensive framework for addressing the pensions agenda over the long-term. 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

After an extraordinary surplus of 4.6% of GDP in 2000 the general government budget posted a slight surplus in 2001 and a roughly balanced position in 2002 and 2003. Part of this surplus decline can be attributed to slower revenue growth in line with the economic slowdown at that time. This lower revenue growth was partly due to lower structural revenue growth, as a result of income tax cuts and tax credits introduced by the government. 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. Even though in 2004 this development was to a good part due to one-off factors (special tax investigations and high revenues from capital gains tax), yielding in a 1.5% of nominal GDP general government surplus, it already pointed to an underlying economic recovery.

Better-than-expected budget outcomes since 2005 due to buoyant economic growth

For 2005 and 2006 the ongoing strong economic development has helped to achieve better-than-planned general government budget positions. A surplus of 1.1% of GDP in 2005 was the result of tax receipts ahead of profile due to expenditure taxes which reflect relatively strong consumer demand, and government expenditures behind target, with capital expenditure facing capacity problems in the construction sector. One-off factors such as the government's refund of nursing home charges which were based on an insecure legal basis and special revenue investigations affected the outcome as well. Compared to an initially planned deficit of 0.6% of GDP for 2006, the government now aims for

2. See "The Long-Term Sustainability of Public Finances in the European Union", European Commission October 2006.
3. See "National Pensions Review", The Pensions Board, October 2005.

a budget surplus of 1% of GDP as a result of the continuation of recent trends of stronger-than anticipated tax receipts. In line with the general development of the economy, the ongoing boom in the construction and housing sector caused the over-performance of stamp duty and capital taxes but indirectly influenced the performance of VAT, income tax and corporation tax as well. An eventual slowdown of the property market thus poses a revenue risk because it may have a negative impact on tax receipts. At the same time, government spending has increased substantially over the last years, mirroring new long-term priorities on health care, education, social welfare and intensified investment into infrastructure and the quality of public services. Furthermore, the government remains committed to continuously strong investment spending into infrastructure and capital investment under the National Development Plan and the Transport 21 Programme. Therefore, public investment spending at about 5% of GNP until 2010 is planned to be well ahead of the EU average level.

Budgets well under control and structurally balanced, even though new priorities arise

It seems to Moody's that the government is well aware of potential risks related to the present pattern of economic growth. On one hand, 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. It seems likely that the government will continue to use the increased (cyclical) scope of fiscal revenues to finance further improvement of public services. On the other hand, Moody's also expects that the government will continue with prudent fiscal management, taking into account that medium-term economic growth (and hence fiscal revenues) will probably turn out to be more moderate 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. In general, Moody's notes that the Irish government's fiscal position remains sound. It seems the government's public finances continue to follow a structurally balanced track. Next year's general elections may pose some uncertainty with respect to pre-election spending increases; however, a significant change in the direction of policies seems unlikely due to the consensus on most major issues among the main political parties. The fiscal consolidation process continues to favor the downward trend in general government debt as a percentage of nominal GDP, now close to the 25% level. Tanking into account funds accumulated in the National Pensions Reserve Fund, net debt at end-2006 is estimated to be at some 16% of GDP.

Peer Group Comparison

In contrast to many other Eurozone governments, Irish authorities have managed to keep general government budget balances well under control. Furthermore, the Irish general government debt ratio has continued its decreasing trend to close to 25% of GDP in 2006, remaining well below Eurozone average at some 69.5% and below the 54.5% mean of advanced industrial countries. The Irish general government debt to revenue ratio at some 72% is largely below the Eurozone average at 153.8% as well as below the mean of advanced industrial countries at 137.8%. While risks to long-term sustainability suggest the necessity of further medium-term reform efforts in many Eurozone countries, Ireland is in a better position than most other Eurozone countries due to its favorable demographic situation and a highly developed pension system.

International Investment Position and Banking Sector

Ongoing FDI inflows reflect a strong interest by high-tech companies to research and produce in Ireland. However, after several years of high positive net FDI, Ireland recorded a high negative net FDI position in 2004/2005. Several factors contributed to the decline: Inward FDI flows turned negative because of loans from Irish-based foreign-owned companies to their affiliates located abroad and a decline in reinvested earnings. [4] Furthermore, outward FDI increased as Irish companies expand internationally in order to take advantage of low cost production capacities abroad.[5]

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). Reflecting the strength of the economy, high levels of capitalization and profitability have strengthened the Irish banks' capacity to weather potential macroeconomic shocks without systemic distress. Asset quality remains sound, reflected by low arrears levels. However, still low interest rates by historical standards underpin strong private-sector credit growth with the ratio of private sector credit to disposable income reaching 132% in 2005. The dominant factor behind that is residential mortgage lending, due to strengthened demand and the fact that Irish banks

4. *The latter one is thought to be a temporary phenomenon as the American Jobs Creation Act 2004, which allows foreign subsidiaries of US multinationals to repatriate funds held abroad back to the US at a reduced tax rate, is a short-term provision.*
5. *See "Foreign Direct Investment: An Analysis of its Significance" Bank of Ireland, Quarterly Bulletin 4, 2006.*

continue to ease credit standards for house purchase loans. As a result, the risk weighting for residential mortgage loans that exceed 80% of the value of the property have been increased recently. 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. Nevertheless, recent stress tests indicate that major lenders have adequate buffers to cover extreme shocks such as a significant increase in unemployment and a sharp decline in house prices. Even a substantial withdrawal of private sector deposits would not seem to cause major problems, given banks' ample liquidity.

Rating History: Ireland

	Foreign Currency Ceilings				Government Bonds		Outlook	Date
	Bonds & Notes		Bank Deposit		Foreign Currency	Local Currency		
Rating Withdrawn [1]	WR	WR	WR	WR	--	--	--	July 15, 1999
Rating Raised	Aaa	--	Aaa	--	Aaa	--	--	May 4, 1998
Review for Upgrade	Aa1	--	Aa1	--	Aa1	--	--	March 18, 1998
Outlook Assigned	--	--	--	--	--	--	Stable	March 7, 1997
Rating Confirmed	--	--	--	--	--	Aaa	--	February 13, 1997
Rating Raised	Aa1	--	Aa1	--	Aa1	--	--	February 13, 1997
Review for Downgrade	--	--	--	--	--	Aaa	--	January 24, 1997
Review for Upgrade	Aa2	--	Aa2	--	Aa2	--	--	January 24, 1997
Rating Raised	Aa2	--	Aa2	--	Aa2	--	--	August 31, 1994
Review for Upgrade	Aa3	--	Aa3	--	Aa3	--	--	June 24, 1994
Rating Assigned	--	--	--	--	--	Aaa	--	September 4, 1992
Rating Assigned	Aa3	--	Aa3	--	Aa3	--	--	July 15, 1987
Rating Assigned	--	P-1	--	P-1	--	--	--	December 4, 1986

[1] Ireland's country ceilings were replaced by the Aaa and P-1 ceilings assinged to the Eurozone.

Related Research

Banking System Outlook:

Banking System Outlook: Ireland, October 2005 (94644)

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)

EU Enlargment – From A Ratings Perspective, July 2004 (88160)

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European Union: New Stability and Growth Pact's Focus on Sustainability Might Prove Positive, May 2005 (92684)

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European Union at the End of 2005: Sharp Disagreements About the Future As Strength Shifts to Member States at Brussels' Expense, November 2005 (95023)

The European Union's ERM2 Experience Justifies Some Credit Enhancement, March 2006 (96914)

The Future of European Capital Markets: Local vs. Global Influences, March 2006 (97013)

Default and Recovery Rates of Sovereign Bond Issuers, 1983-2005, April 2006 (97086)

A Guide to Moody's Sovereign Ratings, August 2006 (98177)

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Revised Country Ceiling Policy, June 2001 (67679)

Piercing the Country Ceiling: An Update, January 2005 (91215)

Revised Foreign-Currency Ceilings to Better Reflect Reduced Risk of a Payments Moratorium in Wake of Government Default, May 2006 (97555)

The Local Currency Deposit Ceiling, August 2006 (98554)

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Ireland

	1998	1999	2000	2001	2002	2003	2004	2005	2006F	2007F
Main Economic Indicators										
Real GDP (%y/y)	9.5	11.6	10.2	5.8	6.0	4.3	4.3	5.5	5.3	5.3
Private Consumption (%y/y)	5.5	6.8	7.2	4.2	3.0	2.5	3.1	6.2	6.6	7.0
Public Consumption (%y/y)	9.7	10.2	11.5	12.8	9.4	5.1	3.8	5.9	4.2	4.2
Gross Fixed Investment (%y/y)	15.1	14.9	7.7	-0.2	3.4	5.8	7.4	12.7	7.0	5.4
Domestic Demand (%y/y)	11.0	8.4	9.9	4.0	4.1	3.4	4.8	7.9	6.3	6.0
Contribution to GDP Growth										
Net Exports	-0.1	4.2	1.7	2.4	2.6	1.5	0.3	-1.2	-0.1	0.1
Domestic Demand	8.3	6.5	8.5	3.4	3.5	2.8	4.1	6.7	5.5	5.3
Stockbuilding	0.5	-0.9	0.4	-0.5	0.1	0.6	-0.7	0.0	0.0	0.0
Unemployment Rate (%y/y)	7.5	5.7	4.3	4.0	4.5	4.7	4.5	4.3	4.3	4.5
GDP Deflator (%y/y)	5.7	3.2	5.5	5.5	5.0	2.5	1.8	3.5	2.5	3.1
CPI (harmonized index, %y/y)	2.1	2.5	5.3	4.0	4.7	4.0	2.3	2.2	2.9	2.7
Comparison: Prices in Eurozone										
CPI (harmonized index, %y/y)	1.2	1.1	2.1	2.4	2.3	2.1	2.1	2.2	2.2	2.1
Indicators of Competitiveness										
Output (% growth)	8.6	11.6	10.2	5.8	6.0	4.3	4.3	5.5	5.3	5.3
Employment (% growth)	8.6	6.2	4.6	3.0	1.8	2.0	3.1	4.6	4.4	3.0
Labor Productivity (% growth)	0.0	5.4	5.3	2.8	4.2	2.3	1.2	0.9	0.9	2.2
Wages (per worker, manufact.,% growth)	4.8	4.5	8.0	7.5	5.5	5.0	6.6	5.0	4.8	4.5
Unit Labor Costs (manufact.,% growth)	4.8	-0.9	2.6	4.6	1.2	2.7	5.4	4.1	3.9	2.2
Comparison: Eurozone										
Output (% growth)	2.9	2.9	3.8	1.9	0.9	0.8	2.0	1.4	2.6	2.1
Employment (% growth)	1.9	2.0	2.5	1.6	0.7	0.5	0.9	1.0	1.6	1.2
Labor Productivity (% growth)	1.0	0.9	1.7	0.5	0.4	0.8	1.6	0.9	1.3	0.9
Wages (% growth)	1.6	2.3	2.8	2.7	2.8	2.8	2.5	1.9	2.2	2.2
Unit Labor Costs (% growth)	0.6	1.4	1.1	2.2	2.4	2.0	0.9	1.0	0.9	1.2
Public Finances (% of GDP)										
General Government Balance	2.4	2.7	4.6	0.8	-0.4	0.3	1.5	1.1	1.2	0.9
Central Government	2.2	2.1	4.3	0.7	0.1	-0.1	1.0	0.6	0.8	0.4
Local Governments	0.1	0.2	-0.1	-0.5	-0.4	0.2	0.2	0.1	-0.1	-0.1
Social Security Funds	0.1	0.4	0.5	0.6	-0.2	0.2	0.3	0.4	0.3	0.1
General Government Revenues	37.1	36.9	36.2	34.2	33.2	33.9	35.5	35.2	36.1	35.9
General Government Expenditures	34.7	34.2	31.6	33.4	33.6	33.5	34.0	34.1	35.0	35.0
Primary Expenditures	31.4	31.9	29.6	31.9	32.3	32.3	32.9	33.1	34.0	34.0
Interest Payments	3.3	2.3	2.0	1.5	1.3	1.2	1.1	1.0	1.0	1.0
Primary Balance	5.7	5.0	6.6	2.3	0.9	1.6	2.6	2.1	2.2	1.9
General Government Debt	53.4	48.4	37.8	35.5	32.2	31.1	29.7	27.4	25.8	24.4
External Accounts										
Total Exports (% volume growth)	23.1	15.5	20.2	8.6	4.5	0.5	7.3	3.9	4.8	4.5
Total Imports (% volume growth)	27.6	12.4	21.7	7.2	2.4	-1.2	8.7	6.5	5.8	6.0
Current Account (% of GDP)	-0.9	-1.1	-1.7	-1.4	0.0	-1.0	-3.1	-3.2	-4.1	-4.2

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