

Research Update:

Republic of Ireland 'AA/A-1+' Sovereign Ratings Affirmed; Outlook Negative

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Overview

- We are affirming the 'AA' long-term and 'A-1+' short-term sovereign credit ratings on the Republic of Ireland. The outlook is negative.
- The affirmation reflects our view that trends in government revenue and expenditure, the fiscal cost to the government of supporting the financial system, and the pace and depth of the economic downturn will remain broadly in line with our estimates as set out in June 2009.
- The ratings on Ireland could be lowered again if asset quality in the banking system deteriorates at a faster pace than we expect and if, as a result of its support for the sector or an even more pronounced downturn in economic growth, the government's fiscal performance weakens further than we currently assume.

Rating Action

On Dec. 18, 2009, Standard & Poor's Ratings Services affirmed its 'AA' long-term and 'A-1+' short-term sovereign credit ratings on the Republic of Ireland. The outlook remains negative. The transfer and convertibility assessment remains 'AAA'.

Rationale

The affirmation reflects our view that trends in government revenue and expenditure, the fiscal cost to the government of supporting the financial system, and the pace and depth of the economic downturn will remain broadly in line with our estimates as set out in June 2009 (see "Related Research" below). Nevertheless, the potential for further increases in the already substantial general government debt burden due to the continued fragility in the Irish banking sector, and weaker-than-expected outturns in the public finances due to the ongoing recession, have led us to maintain the negative outlook.

On Dec. 9, 2009, the government set out its 2010 budget, which included a €4 billion (2.5% of GDP) expenditure-led fiscal adjustment. We believe the specific measures detailed in the budget provide a clear indication of the government's intent to put the public finances on a more sustainable footing. Budgetary measures announced include permanent reductions in expenditure, and structural reductions in public sector pay and social spending. The government has also indicated a further €2 billion (1.2% of GDP) of reductions in capital expenditure over 2011-2012, and estimates a further €4 billion (2.3% of GDP) in expenditure and revenue adjustment over the period, after which the general government deficit is projected to stand at 7.2% of GDP. We expect a broadly

similar trajectory for government borrowing.

However, as we treat the debt issuance of the National Asset Management Agency (NAMA) as a direct government obligation--despite the entity being set up as an special purpose vehicle and therefore ostensibly off-balance sheet--our estimate of gross general government debt in 2010 (113% of GDP) is £54 billion (33% of GDP), higher than the official forecast. Our projection of net debt in 2010 (92% of GDP) also includes our estimate of the cost to the government of recapitalizing domestic financial institutions (€20-€25 billion).

NAMA's fundamental purpose to remove the riskiest lending from the balance sheets of the country's main domestically owned commercial banks remains unchanged. Under the legislation approved by parliament on Nov. 12, 2009, the government plans to transfer €77 billion of performing and impaired property-related exposures and associated commercial lending from Irish banks to NAMA. NAMA is expected to acquire the assets for €54 billion, a significant discount to their current face value. The purchase of these assets, in turn, is to be financed by the issuance of government-guaranteed bonds by a special purpose vehicle. The government has announced that its objective is for NAMA to pay down some or all of this additional debt in future years from the proceeds of maturing loans and from asset disposals and recoveries. In our view, this will depend on the price it pays for the assets and their future performance; cash flows from the purchased assets could fall below its funding costs if their underlying performance worsens compared with NAMA's expectations at the time of purchase.

Ireland's membership of the European Economic and Monetary Union protects the economy from exchange rate crises, but also puts greater onus on economic and fiscal policy in the absence of exchange rate flexibility. The Irish economy's high level of labor market flexibility is expected to result in a sharp reduction in private sector wages, which we believe would make some inroads into regaining Ireland's lost competitiveness. However, we expect this small, open economy will remain dependent on a pick-up in demand from key trading partners in order to achieve positive GDP per capita growth in the medium term. The economic adjustment is likely to be painful, as deflation will increase the real cost of the private sector's substantial debt burden.

Outlook

The ratings on Ireland could be lowered again if asset quality in the banking system deteriorates at a faster pace than we expect and if, as a result of its support for the sector or an even more pronounced downturn in economic growth, the government's fiscal performance weakens further than we currently assume. The ratings could also be lowered if the average maturity on the government's debt, currently above six years, were to materially shorten for a sustained period. Conversely, the outlook could be revised to stable if the banking sector stabilizes more quickly and at a lower fiscal cost to the government than we now think likely.

Related Research

- Ireland Rating Lowered To 'AA' On Potential Fiscal Cost Of Weakening Banking Sector Asset Quality; Outlook Negative, 8 June 2009
- Republic of Ireland Rating Lowered To 'AA+'; Outlook Negative On Public Finance Concerns And Economic Growth Potential, March 30, 2009
- Republic of Ireland Outlook To Negative On Concerns About Public Finances; Ratings Affirmed, Jan 9, 2009
- Sovereign Credit Ratings: A Primer, May 29, 2008

Ratings List

Ratings Affirmed
Republic of Ireland

Sovereign Credit Rating
AA/Negative/A-1+

N.B.--This list does not include all ratings affected.

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