

Credit Analysis

**Ireland**

**Ratings**

Foreign Currency	
Long-Term IDR	AA-
Short-Term IDR	F1+
Local Currency	
Long-Term IDR	AA-
Country Ceiling	AAA

**Outlooks**

Foreign-Currency Long-Term IDR	Stable
Local-Currency Long-Term IDR	Stable

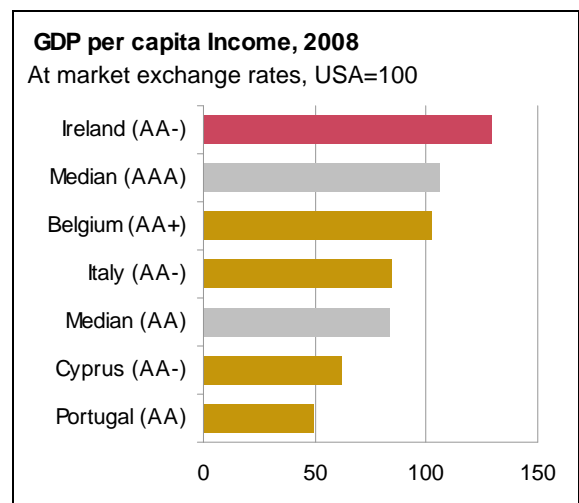
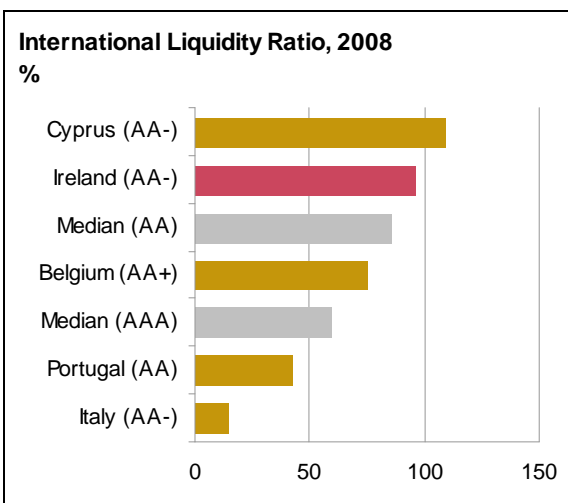
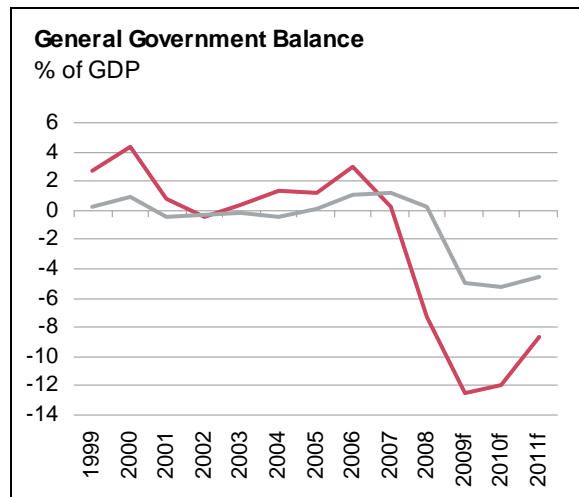
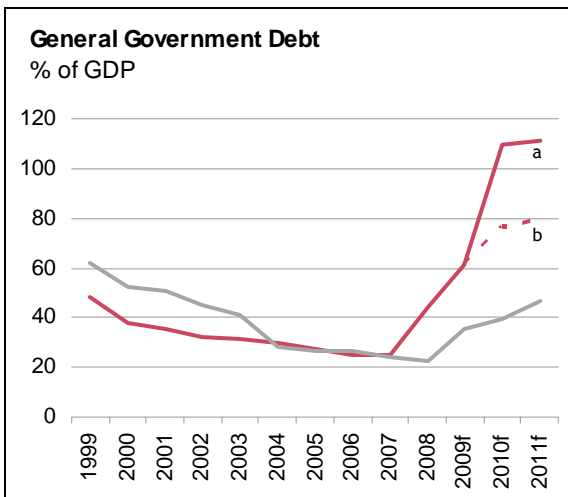
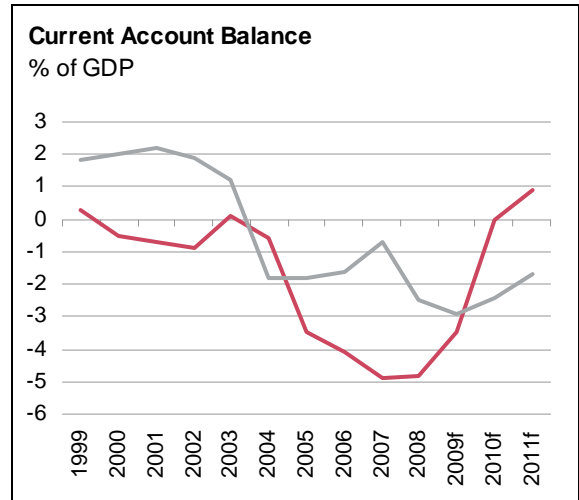
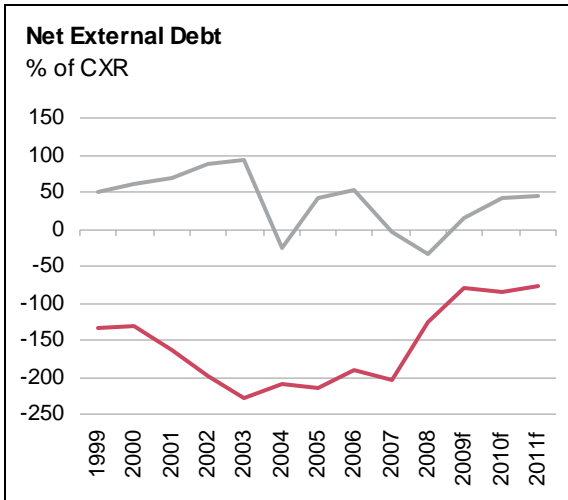
**Rating Rationale**

- The decision to downgrade Ireland’s sovereign ratings to ‘AA-’ reflects the severe impact of the credit cycle on its economy, banking system and public finances. A fierce economic adjustment is underway, with nominal GDP expected to fall a cumulative 14% between 2007 and 2010, exacerbated by deflationary and pro-cyclical budget tightening introduced as an emergency response to the crisis.
- The fiscal crisis is partly the result of excessive reliance on property receipts during the boom. An overall budget surplus in 2007 concealed what is now known to have been a gaping structural deficit of roughly 8% of GDP. Even taking into account the consolidation measures of the past year, Fitch Ratings expects the overall deficit/GDP to be 12.5% in 2009 and 12% in 2010.
- Fitch expects general government debt (on the official definition) to jump to 80% of GDP by 2011. Combined with the drop in revenues and rise in the effective interest rate, this will cause interest payments to constitute over 15% of tax revenues over the medium term, among the worst of all high-grade sovereigns. Broader government liabilities, including debt issued to purchase bank assets are expected to reach 111% of GDP in 2011.
- Ireland’s banking system has been one of the world’s worst affected during the global crisis. Poor lending standards and negative real interest rates led to a near-tripling of the banks’ aggregate loan book from 2003-2008, leaving the them highly exposed to the overheated property market. The domestic banks were also highly reliant on foreign wholesale funding. From September 2008 onwards, the banks entered both a liquidity and solvency crisis.
- However, in tackling the domestic crisis, the government’s policymaking has been timely, effective and transparent. Bank guarantees, nationalisation, recapitalisation and an asset carve-out scheme have helped avoid total bank systemic failure, whose knock-on effects on credit to the real economy would have been dire. Consolidation efforts have been significant, not least as the economy is undergoing a far larger contraction than rating peers, and the government has set out a medium-term fiscal framework to restore budget sustainability. Ireland’s membership of the euro area has also been crucial in maintaining confidence, with banks receiving extensive ECB liquidity support.
- The ‘AA-’ rating is underpinned by Ireland’s structural strengths: an advanced, diversified economy with high income per capita (USD37,350 in 2008 in purchasing power parity terms, among the highest of all Fitch-rated sovereigns). Governance in Ireland is stronger than ‘AA’-range peers and in line with ‘AAA’ countries. The country’s institutional strengths foster confidence in its ability and willingness to honour its public debt commitments.

**Key Rating Drivers**

- Fitch does not expect Ireland’s credit profile to deteriorate significantly further from this rating level, as reflected in the Stable Outlook. The agency anticipates that the government measures, backstopped by ECB liquidity support, will be successful in stabilising and rehabilitating the banking sector. Furthermore, Fitch expects the government will rein in its deficit sufficiently to stabilise the debt/GDP ratio and that Ireland will see a return to growth from 2011. The rating is robust to some economic and/or fiscal disappointments relative to current expectations.

**Peer Comparison**



Ireland

Medians

<sup>a</sup>Fitch definition (including guaranteed NAMA bonds)

<sup>b</sup>Official definition (excluding guaranteed NAMA bonds)

**Rating Factors**

**Summary: Strengths and Weaknesses**

Rating Factor	Macroeconomic	Public Finances	External Finances	Structural Issues
Status	Weakness	Weakness	Strength	Neutral
Trend	Stable	Negative	Stable	Stable

Note: relative to 'AA' category

**Strengths**

- Ireland has structural strengths including high income per head and strong governance. A competitive business environment and tax regime and a high level of human capital have attracted large FDI inflows. This in turn has contributed to strong productivity gains and high potential GDP growth rates.
- Provided that the country is able to successfully navigate its current fiscal and banking crisis, its flexible and diversified economy and high-value-added export sector brightens the medium-term macroeconomic outlook.
- As a small country with an outsized financial sector and a large external balance sheet, euro area membership is a rating strength as it removes the threat of a currency crisis and gives banks much-needed access to ECB liquidity support.

**Weaknesses**

- The Irish banking system is on life-support and is a clear rating weakness. Its near-collapse has damaged the sovereign's creditworthiness through capital injections, a large carve out of bad assets and an explicit guarantee on liabilities worth around 200% of GDP at end-2008.
- Over-reliance on cyclical property-related receipts has helped bring about a fiscal crisis, with the government rapidly moving from a balanced budget/low debt position in 2007 to an expected deficit of 12.5% of GDP in 2009 with debt at 61% of GDP and set to become among the highest of all 'AA'-range peers.
- Ireland's relatively small size has hindered the government's policy flexibility due to bond market pressures. Yield spreads widened to a peak of 260bp over bunds in Q109 primarily due to market concerns over the banking system.
- The recession in Ireland has been fierce, even by the standards of the global crisis. Nominal GDP is expected to contract a cumulative 14% between 2007 and 2010 as the government has been forced to exacerbate the downturn through pro-cyclical and deflationary budget tightening. Private sector de-leveraging pressures are likely to be more severe in Ireland than in peer economies.
- The government's consolidation programme has boosted its fiscal credibility. However, the sheer size of the necessary adjustment over the medium term raises the risk of slippage, which would exacerbate public debt dynamics.

**Local Currency Rating**

For euro area sovereigns, Fitch sets equal Local-Currency (LC) and Foreign-Currency (FC) Ratings (at 'AA-' in the case of Ireland). Euro area sovereigns have limited ability to monetise their domestic debt stock and lack preferential access to domestic capital markets. Also, the EUR's status as a reserve currency makes the prospect of a currency crisis very unlikely. This implies that there is no significant difference in the sovereign's ability to service FC or LC (ie EUR) debt.

**Country Ceiling**

Fitch assigns a single 'AAA' Country Ceiling for all 16 euro area members. These sovereigns lack preferential access to foreign exchange and are unable to impose capital controls. Therefore the risk that a resident entity will be unable to transfer funds to a non-resident creditor due to an inability to convert EUR into FC is considered independent of the host sovereign's default risk.

**Peer Group**

Rating	Country
AA	Hong Kong
	Japan
	Kuwait
	Portugal
	Slovenia
AA-	Ireland
	Cyprus
	Italy
	Saudi Arabia
A+	China
	Czech Republic
	Korea
	Malta
	Slovakia
	Taiwan

Source: Fitch

**Rating History**

Date	Long-Term Foreign Currency	Long-Term Local Currency
4 Nov 09	AA-	AA-
8 Apr 09	AA+	AA+
16 Dec 98	AAA	AAA
14 July 98	AA+	AA+
26 Oct 95	AA+	AAA
10 Oct 94	AA+	-

Source: Fitch

## Outlook and Key Issues

Fitch has downgraded Ireland's sovereign ratings from 'AA+' to 'AA-' and changed the Outlook to Stable. The downgrade reflects adverse fiscal dynamics and rapidly mounting government liabilities, as well as the severe economic contraction. The agency expects the public deficit in 2009 to come in at 12.5% of GDP. Even assuming the government is able to consolidate the budget over the coming years, general government debt (official definition) will peak at 80% of GDP. Government liabilities rise to over 110% of GDP when fiscal funding for the carve out of bad bank assets is taken into account. The weakness of the domestic banking system is also inconsistent with a higher sovereign rating. However, Fitch judges the risks to the rating to be balanced at 'AA-', hence the Stable Outlook.

## Support for the Banks

The government announced the creation of the National Asset Management Agency (NAMA) in April 2009. It is the largest asset carve-out scheme (as a share of GDP) of the global crisis to date. In September 2009, bank assets with a book value of EUR77bn (45% of GDP) were identified as "likely to be transferred to NAMA", two-thirds of which are land and development loans; the rest are associated loans. In exchange for these assets, NAMA will issue the banks with EUR54bn of government-guaranteed bonds. Cash-flow generating loans (around 40% of the portfolio) are expected to cover most of the interest payments on these "NAMA bonds".

This purchase represents an aggregate discount of 30% on the assets' book value, albeit still 15% above their estimated current market price. The government believes it can recover this premium over the medium to long term as the property market recovers. A very rough calculation suggests a 50% loss rate on the loans expected to be transferred would ultimately cost the government around EUR15bn (9% of GDP). This is a worse result than Fitch expects, but serves to illustrate that the net cost of NAMA will be far below the gross outlay (33% of GDP). Eurostat has agreed to classify the guaranteed NAMA bonds as private sector debt as the bad loans will be held in a special purpose vehicle (SPV) with minority public ownership. The draft legislation also provides for the recovery of any final loss on NAMA by means of a levy on bank profits. However, the SPV will be extremely thinly capitalised and the option of a bank levy in 10-15 years' time does not materially change the government's revenue-raising potential. Fitch treats the NAMA bonds as government liabilities for the purposes of international comparison.

### NAMA Loss Matrix

(EURbn)

Loss rate on book value <sup>a</sup>	NAMA loss
10%	15.4
20%	7.7
30%	0.0
40%	7.7
50%	15.4

<sup>a</sup> EUR77bn, including estimated interest roll-up  
Source: Fitch estimates

NAMA represents a significant risk transfer from the domestic banks to the government, leaving aside the small amount of NAMA's subordinated-debt (EUR2.7bn) to be held by the banks. While this expansion of the sovereign's risk profile was one of the reasons behind Fitch's downgrade of Ireland's 'AAA' rating in April, the agency expects NAMA to go a long way towards restoring the banking sector to health over the next few years. The NAMA announcement in April did much to restore calm to the markets, with bank credit default swap (CDS) spreads narrowing markedly.

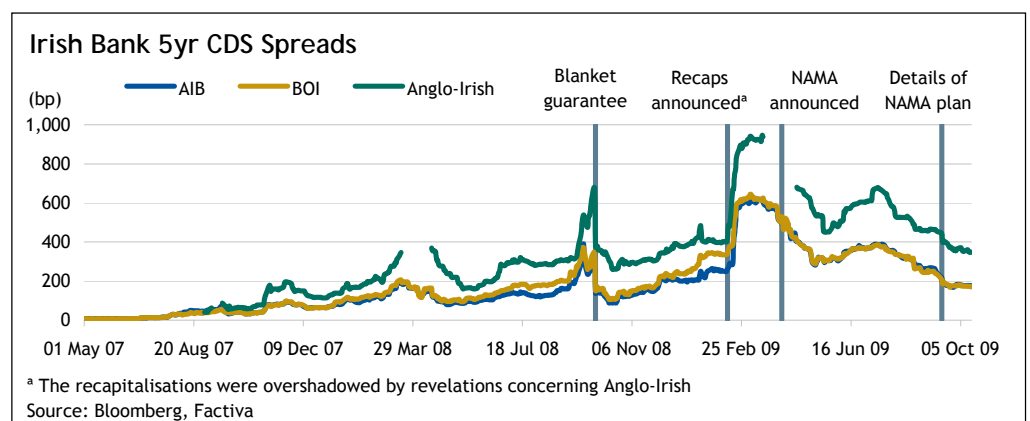
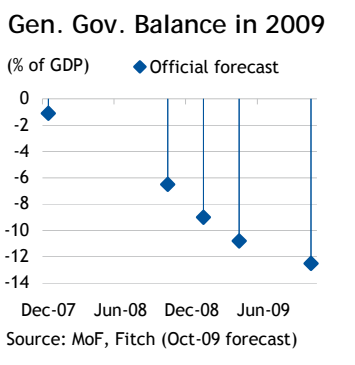
The government has announced plans for a new scheme which will allow participating institutions to issue debt of up to five-year maturity under state guarantee. However, the guarantee fee – based on the banks' CDS spreads – will be significantly higher than that charged for the existing scheme. Meanwhile, interbank lending rates remain higher than elsewhere in Europe. This rise in Irish banks' funding costs, combined with mortgage lending rates amongst the lowest in Europe, will squeeze profitability and inevitably lead to higher lending rates being passed on to customers.

As the bank loans earmarked for NAMA will be bought at below book value, the asset carve-out will crystallise losses for the banks. On top of that, losses stemming from residential mortgage lending will also be significant. House prices have fallen by 24% from their peak in January 2007, and Fitch expects the total peak-to-trough decline could exceed 40%, reflecting adverse household income developments as well as a large property overhang. Mortgage default rates are currently very low partly due to political and judicial forbearance. However, sharp nominal price declines, a dramatic increase in unemployment and higher lending rates all point to an inevitable increase in instances of default. Fitch estimates the system will require EUR5bn-10bn of additional capital to maintain a 4% core Tier 1 ratio through the cycle. The finance minister said in September that he would prefer the banks to raise private capital. However, the government stands ready to step in if this is not forthcoming. The government debt projections in this report assume an additional EUR5bn of state capital injections.

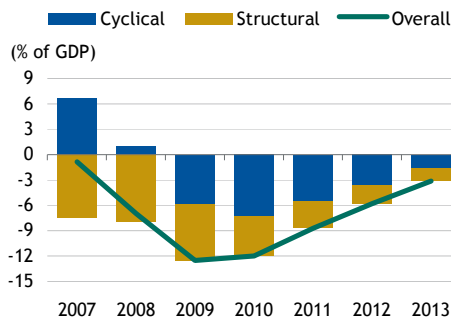
**Public Finances**

The scale of fiscal consolidation required in Ireland is daunting. Over a relatively short period of time, it became apparent that the government had been sitting on what was an unprecedented fiscal deficit. This had been brought about by several years of pro-cyclical fiscal easing compensated by windfall property tax receipts. The 2009 budget was reopened twice in rapid succession (in February and April).

The government is targeting a return to the Maastricht deficit limit of 3% of GDP by 2013. Even with this long timeframe, the adjustment will be painful. In February, EUR1.8bn of expenditure cuts for 2009 were announced (primarily through a levy on public sector pay – effectively a pay cut of 10% in aggregate). Further measures were announced in April's supplementary budget: spending cuts of EUR1.5bn and (mainly income) tax hikes worth EUR1.8bn in the year remaining. On an annualised

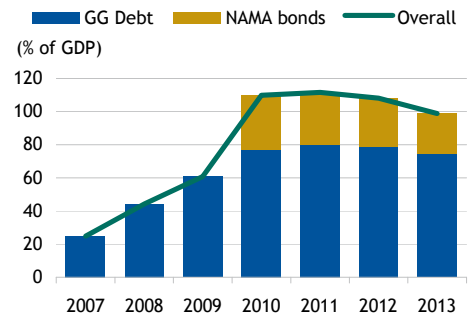


**General Government Balance**



Source: Fitch

**General Government Liabilities**



Source: Fitch, NTMA

basis, this represents a total planned tightening of EUR7.4bn or 4.5% of GDP. This stands in stark contrast to the 2009 fiscal loosening in almost all other advanced economies (averaging around 2% of GDP).

With two months in the year remaining, Fitch expects a tax shortfall of EUR2bn, while expenditure is broadly on target. This would bring the full-year deficit to 12.5% of GDP. The government committed itself in April to making good any shortfall, on top of the EUR4bn of additional tightening needed in 2010. To that end, it set up the independent McCarthy Commission to review current expenditure and produce cost-cutting recommendations, as well as the Commission on Taxation. The 2010 budget (due 9 December) should contain the final decision on where the knife will fall. There will also be further cuts to capital expenditure (EUR0.7bn in 2010 and EUR1.0bn in 2011).

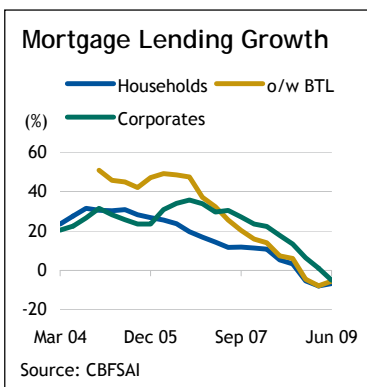
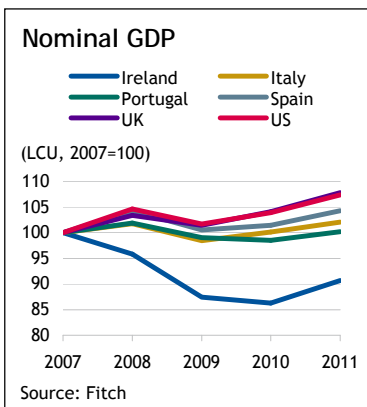
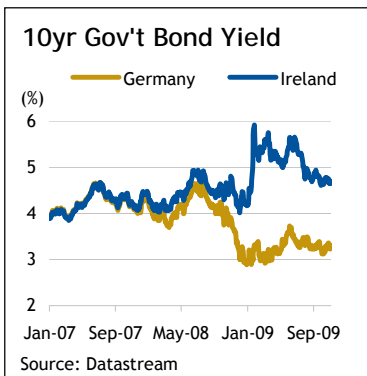
While the government has tackled the fiscal crisis effectively to date, Fitch believes that there are substantial risks of slippage in 2010 and 2011 as the McCarthy Commission's recommendations are unpopular and politically challenging. Furthermore, to keep the Green Party in the coalition government, Fianna Fáil has made key fiscal concessions, pledging to hire more teachers and scrapping plans to introduce university tuition fees.

The government is planning for most of the future adjustment to be made on the expenditure side as there is a strong political desire to maintain the Irish low-tax model. While this may be beneficial from a supply-side perspective, it nonetheless makes the process all the more challenging as policy options are reduced. For example, corporation tax is very unlikely to be raised for fear of jeopardising FDI inflows. High interest payments will further reduce fiscal flexibility: next year Ireland's interest/tax ratio will be higher than all other EU countries but Greece, reflecting the surge in borrowing, a higher sensitivity to market yields due to a relatively short average duration and collapsed tax revenues. Fitch therefore considers it likely that further revenue raising measures will be undertaken, especially as tax revenue in 2008 was already a low 32% of GDP. Having both high public debt and a low-tax environment may not prove possible.

**Economic Outlook**

Ireland's recession is deep and prolonged compared to its peers, with three years of economic contraction expected. The accompanying price deflation has caused an even sharper fall in nominal GDP. However, in contrast to earlier in the year, the risks to the outlook now appear to be more balanced, albeit still large. Fitch assumes that lending growth will be subdued over the medium term, and that commercial lending rates will rise. The combination of private sector deleveraging and public sector consolidation will also continue to act as a drag on consumption next year. All this will probably keep inflation and GDP growth under zero in 2010.

Although credit growth is currently in negative territory, the risk of a further precipitous fall in credit supply has been mitigated by government intervention in



the banking system. NAMA will drastically boost the banks' liquidity as they will be able to repo their newly-acquired government securities with the ECB. Meanwhile, the government may increase pressure on banks to lend more, as is happening in many other countries. Recent bank lending surveys suggest banks are tightening their lending standards less than 9-12 months ago and that the decline in credit demand is decelerating.

However, other factors may act as a drag on new lending. Firstly, the banks' (post-NAMA) loan/deposit ratios will still be high and they may try to reduce their exposure to wholesale funding by shrinking their loan books. Secondly, the private sector is more highly leveraged than most other peer countries and will also likely seek to shrink its balance sheet, especially in the face of higher borrowing costs and falling incomes. The chance of these adjustments happening rapidly poses a downside risk to the forecast. One negative scenario is that the banking sector further restricts domestic lending, with harmful and self-reinforcing effects on the real economy causing a protracted period of stagnation. Fitch believes NAMA has gone a long way towards neutralising this threat by boosting the banks' liquidity as well as removing the worst assets from their balance sheets.

Ireland is experiencing a period of deflation. Both headline and core inflation turned negative in 2009. Nominal wages have fallen in the public sector and, although the statistical evidence is ambiguous, Fitch believes private-sector wages will also decline and may be doing so already.<sup>1</sup> While at first glance this is concerning, raising the spectre of a sustained debt-deflation spiral, the small and open nature of Ireland's economy makes this prospect unlikely in the absence of more widespread deflation in the euro area. Nonetheless, falling wages in the near term make both private sector deleveraging and fiscal tightening more challenging.

However, wage declines will inevitably improve Ireland's international competitiveness and as the global economy recovers, Ireland should benefit from an export-led recovery. Fitch is forecasting 3% growth in 2011 but there is an upside risk to this forecast: Ireland may enjoy a period of higher growth as it utilises considerable spare capacity and benefits from a renewed competitiveness.

<sup>1</sup> The Economic and Social Research Institute points out that recent poor income tax performance suggests average earnings are in fact below the official wage estimates due to reduced working hours and/or underreporting.

## Forecast Summary

	2005	2006	2007	2008	2009 <sup>f</sup>	2010 <sup>f</sup>	2011 <sup>f</sup>
<b>Macroeconomic Indicators and Policy</b>							
Real GDP growth (%)	6.4	5.7	6.0	-3.0	-7.5	-1.0	3.0
Consumer prices (annual average % change)	4.0	2.3	2.2	2.7	-1.5	-0.7	1.0
Short-term interest rate (%) <sup>a</sup>	2.4	3.6	4.7	3.0	1.3	1.0	1.5
General government balance (% of GDP)	1.2	3.0	0.2	-7.3	-12.5	-12.0	-8.7
General government debt (Fitch defn., % of GDP) <sup>b</sup>	27.3	24.7	24.9	44.1	60.9	109.8	111.4
General government debt (Eurostat defn., % of GDP)	27.3	24.7	24.9	44.1	60.9	76.8	80.1
EUR per USD (annual average)	0.81	0.80	0.73	0.68	0.72	0.70	0.70
Real effective exchange rate (ULC, 2000=100)	109.3	108.0	113.3	120.8	114.9	111.0	108.0
<b>External Finance</b>							
Current account balance (USDbn)	-7.2	-9.1	-12.7	-12.7	-8.0	0.0	2.2
Current account balance (% of GDP)	-3.5	-4.1	-4.9	-4.8	-3.5	0.0	0.9
Current account balance plus net FDI (% of GDP)	-25.8	-11.1	-3.3	-14.2	0.6	8.5	9.0
Net external debt (USDbn)	-483	-484	-643	-441	-258	-288	-272
Net external debt (% of GDP)	-240	-218	-248	-166	-113	-122	-110
Net external debt (% of CXR)	-216	-189	-204	-127	-80	-86	-78
Official international reserves including gold (USDbn)	0.9	0.8	0.9	1.0	0.8	0.8	0.8
Official international reserves (months of CXP cover)	0.0	0.0	0.0	0.0	0.0	0.0	0.0
External interest service (% of CXR)	14.4	18.4	25.0	23.7	23.3	20.2	17.7
Gross external financing requirement (% int. reserves)	4872	22,520	27,794	30,776	21,737	25,975	25,157
<b>Memo: global forecast summary</b>							
<b>Real GDP growth (%)</b>							
US	3.1	2.7	2.1	0.4	-2.5	1.8	2.5
Japan	1.9	2.0	2.3	-0.7	-5.8	1.3	1.1
Euro area	1.8	3.1	2.7	0.6	-4.1	0.5	2.0
World	3.3	3.9	3.6	1.7	-3.3	1.4	2.5
<b>Commodities</b>							
Oil (USD/barrel)	54.4	65.4	72.6	97.0	60.0	65.0	70.0

<sup>a</sup> Money market rate - one month fixed (annual average).

<sup>b</sup> Including government-guaranteed NAMA bonds.

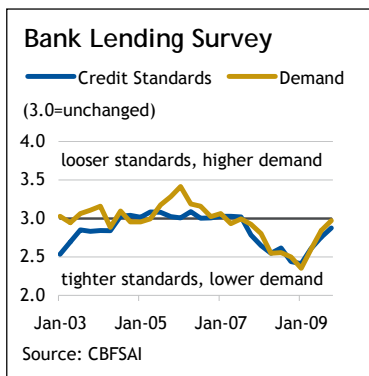
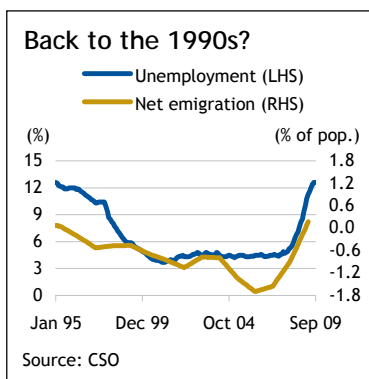
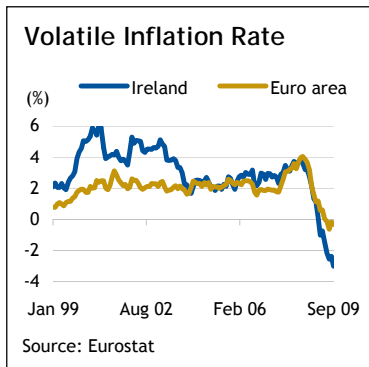
Source: Fitch

**Comparative Analysis: Macroeconomic Performance and Policies**

**Ireland**

	2008						
	Belgium 'AA+'	Portugal 'AA'	Ireland 'AA-'	Cyprus 'AA-'	Italy 'AA-'	'AA' median	'AAA' median
Real GDP(5yr average % change)	2.3	1.1	4.0	4.0	0.9	3.6	2.7
Volatility of GDP (10yr rolling SD)	1.1	1.5	3.6	1.0	1.3	1.4	1.3
Consumer prices (5yr average)	2.6	2.6	3.3	2.5	2.4	2.8	2.1
Volatility of CPI (10yr rolling SD)	0.9	0.7	1.3	1.3	0.5	1.1	0.7
Years since double-digit inflation	33	17	25	27	24	n.a.	n.a.
Unemployment rate	7.0	7.6	6.0	3.7	6.8	4.4	5.7
Type of exchange rate regime	EMU	EMU	EMU	EMU	EMU	n.a.	n.a.
Dollarisation ratio	-	10.0	29.2	52.0	0.0	13.3	18.5
REER volatility (10yr rolling SD)	3.2	1.2	3.8	5.5	3.7	3.7	3.0

Source: Fitch



**Strengths**

- Membership of the euro area has lowered interest rates, anchored inflation expectations, removed the threat of a currency crisis and given Irish banks access to hard-currency liquidity support from the ECB.
- Economic growth in Ireland has outstripped most of its high-grade peers since the 1990s, especially those in the EU15. Ireland has been very successful at attracting FDI through a favourable tax regime and high levels of educational attainment. Fitch assumes potential growth will slow to around 2%-3% over the medium term but sees a fair prospect of an export-led recovery from 2011.
- Wages and prices are relatively flexible. The nominal declines in both now underway should lead to a sharper economic recovery. In the absence of deflation abroad, Fitch does not see prolonged deflation in Ireland as a significant risk to economic recovery, due to the economy's open nature and the ECB's inflation target anchor.

**Weaknesses**

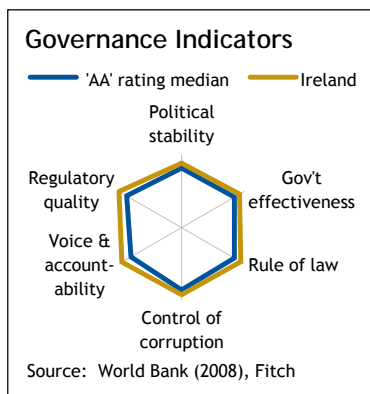
- Little action was taken to counteract the overheating construction and property markets. On the contrary, the fiscal stance was loosened over the boom period and no significant regulatory action was taken to slow credit growth or otherwise mitigate the banks' exposure to these markets. One consequence of this is that GDP volatility in Ireland is significantly higher than EU15 peers.
- The government's poor fiscal position has led to an increase in the Irish risk premium. Meanwhile, bank profitability is under severe pressure from high funding costs, which will be passed on through higher lending-rates. Both these factors will increase the cost of capital for Irish borrowers relative to the euro area, with negative growth implications.
- The private sector is relatively indebted and its nominal income is falling. Deleveraging pressures may hinder an economic recovery and cause a period of stagnation over the medium term. While this is a downside risk to the outlook, it is not Fitch's central scenario. Incomes are expected to stabilise past 2010 and the central bank's recent lending surveys suggest credit supply and demand may be recovering from their lows in early 2009.
- The rate of unemployment in Ireland has risen sharply from 4.6% in September 2007 to 12.6% in September 2009. This is largely due to the collapse in output of the (labour-intensive) construction sector. A broad-based recovery will be needed to bring the unemployment rate down; a strong recovery in the capital-intensive "modern sector" alone would not have a significant effect on employment.

**Comparative Analysis: Structural Features**

**Ireland**

	2008						
	Belgium 'AA+'	Portugal 'AA'	Ireland 'AA-'	Cyprus 'AA-'	Italy 'AA-'	'AA' median	'AAA' median
GNI per capita PPP (USD, latest)	34,760	22,080	37,350	24,040	30,250	32,145	37,280
GDP per capita (USD, mkt exchange rates)	47,560	22,808	59,996	28,929	39,034	38,806	49,221
Human Development Index (percentile, latest)	90.6	83.9	97.2	84.5	88.9	88.6	93.3
Ease of Doing Business (percentile, latest)	89.9	79.7	96.1	-	70.7	89.9	92.7
Trade openness (CXR and CXP % GDP)	118.4	51.3	132.7	78.4	36.3	113.5	110.3
Gross domestic savings (% GDP)	23.4	12.9	32.5	12.9	20.7	28.7	26.5
Gross national savings (% GNP)	21.1	10.5	20.6	6.7	18.2	25.0	25.4
Gross domestic investment (% GDP)	23.9	22.2	22.1	24.3	21.2	23.1	21.9
Private credit (% GDP)	94.5	147.0	218.1	235.2	105.0	142.1	129.6
BSR Indicators	D3	B2	D3	C2	C2	n.a.	n.a.
Bank system CAR	16.2	10.3	10.6	12.0	10.8	12.2	12.8
Foreign bank ownership (% assets)	25.0	11.0	32.0	43.1	7.0	n.a.	n.a.
Public bank ownership (% assets)	0.0	28.0	0.0	1.1	0.0	n.a.	n.a.

Source: Fitch and World Bank



**Strengths**

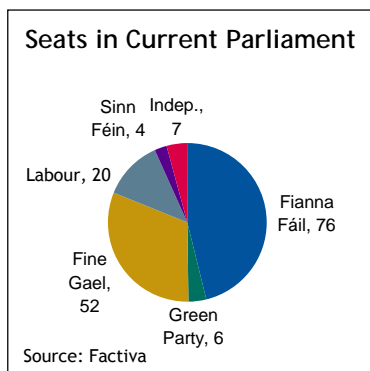
- Ireland has one of the highest GDP per capita levels of all Fitch-rated sovereigns, although this will fall. It provides the Irish economy with higher debt tolerance than most 'AA' peers and somewhat mitigates the high level of debt in the economy. Governance as measured by the World Bank is above the 'AA' median on every measure and in line with the 'AAA' median.
- Ireland's success in attracting FDI stems from its competitive business environment and tax regime and its high level of human capital. Large FDI inflows – and the accompanying productivity gains – played a large part in the Irish convergence of the 1990s.
- Although the regulatory framework in Ireland has proven inadequate, the government's response to the unfolding crisis has been strong. The budgeting process has been responsive and has laid out a medium-term path to restore fiscal sustainability. Good debt management has also helped Ireland weather the adverse market conditions and greatly increased borrowing needs.

**Weaknesses**

- Ireland's Banking System Indicator (BSI) has fallen to 'D' since the start of the crisis. Together with Belgium, this is the lowest score for a high-grade sovereign. All major Irish banks are rated at the sovereign support floor, implying that their creditworthiness stems exclusively from state support.
- The near-collapse of the system has imposed a heavy burden on both the sovereign and the Irish economy as a whole. The private sector is heavily reliant on bank financing. Domestic bank credit stands at well over 200% of GDP, making Ireland an outlier even compared with high-grade peers.

**Commentary**

The Fianna Fáil–Green coalition has so far passed a number of hurdles, including the Lisbon treaty referendum and agreement over the NAMA bill, despite historically low popularity. The scale of the fiscal problems has put the government in the undesirable position of making Ireland's largest post-war fiscal correction during its worst post-war recession. There is therefore a risk the government will not see out its full term to 2012. While early elections and coalition bargaining may disrupt policymaking, Fitch notes that there is broad consensus among the main parties of the need to repair the budget and maintain the competitive business environment.

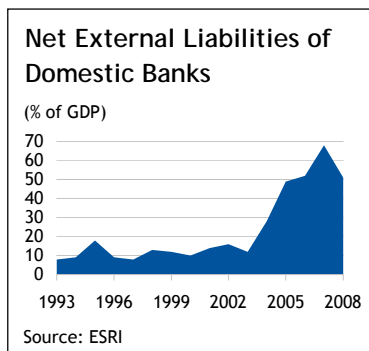
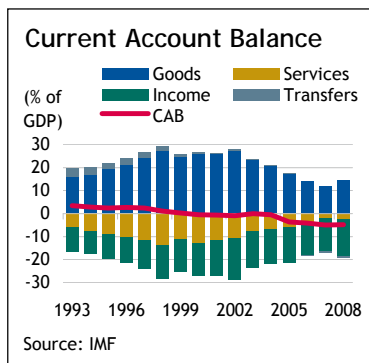
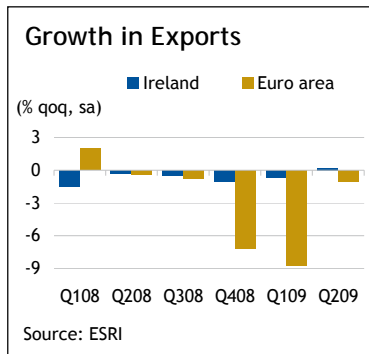


**Comparative Analysis: External Finances**

**Ireland**

	2008					Last 10 years	
	Belgium 'AA+'	Portugal 'AA'	Ireland 'AA-'	Cyprus 'AA-'	Italy 'AA-'	'AA' median	'AAA' median
GXD (% CXR)	232.0	427.4	569.6	527.1	322.3	255.8	300.7
GXD (% GDP)	271.8	193.5	742.4	365.8	111.5	123.9	160.1
NXD (% CXR)	-38.3	146.7	-126.4	-48.2	91.5	64.9	17.7
NXD (% GDP)	-44.9	66.4	-164.7	-33.5	31.7	22.3	11.0
GSXD (% GXD)	30.6	31.7	2.6	4.3	42.0	17.0	19.2
NSXD (% CXR)	64.1	99.0	10.3	-7.3	107.0	1.9	14.4
NSXD (% GDP)	75.1	44.8	13.5	-5.1	37.0	1.2	9.1
SNFA (USDbn)	-376.2	-107.5	-11.9	1.3	-847.6	0.1	-0.1
SNFA (% GDP)	-74.7	-44.1	-4.5	5.1	-36.8	0.4	-2.3
Ext. debt service ratio (% CXR)	26.7	71.0	79.9	14.9	73.2	30.9	35.3
Ext. interest service ratio (% CXR)	12.0	18.4	19.9	13.0	13.6	10.0	10.9
Liquidity ratio (latest)	75.3	42.6	96.2	109.3	14.4	48.8	57.5
Current account balance (% GDP)	-2.5	-12.2	-4.8	-18.0	-3.4	1.2	2.7
CAB plus net FDI (% GDP)	-22.6	-11.6	-14.2	-15.5	-4.8	-0.4	1.3
Commodity dependence (% CXR, latest)	15.2	14.1	7.2	6.5	10.2	12.8	11.3
Sovereign net FX debt (% GDP)	-1.9	-4.5	-0.4	3.7	-4.4	n.a.	n.a.

Source: Fitch



**Strengths**

- Exports have performed well relative to other high-grade economies, thanks to the presence of foreign-owned firms concentrated in a few high-value-added goods and services sectors. Exports in H109 held up impressively well thanks largely to the performance of the chemical and pharmaceutical sector (which accounted for 51% of goods exports in 2008).
- Fitch considers it likely that the current account deficit will disappear in 2010. In the near term, this is due to the sharp drop in imports following the collapse in private consumption and investment. Over the medium-term, nominal wage falls will see Ireland regaining its competitiveness.
- Ireland's gross external debt (GXD) is six times the 10-year 'AA' median as a percentage of GDP. However, any external liquidity concerns such large external leverage may raise are rendered moot by Ireland's membership of the euro area. In any case, the country is a substantial net external creditor (250% of GDP in 2007) and its liquidity ratio is higher than for most of its peers.

**Weaknesses**

- During the boom years, real-estate investment ran well ahead of private savings. Construction was mainly funded by the banks, which turned abroad to fund their rapid expansion. Thus the net external liability position of the domestic (ie Irish-owned) banking system rose sharply from 12% of GDP in 2004 to 68% of GDP in 2007. Over the next few years, Fitch expects to see significant external deleveraging as the banks shrink their balance sheets and private savings increase.
- Ireland's overall international investment position (ie all financial assets and liabilities) was a net liability of about 18% of GDP in 2007, slightly worse than most high-grade peers. This feeds back negatively on the current account through net income payments to the rest of the world.

**Commentary**

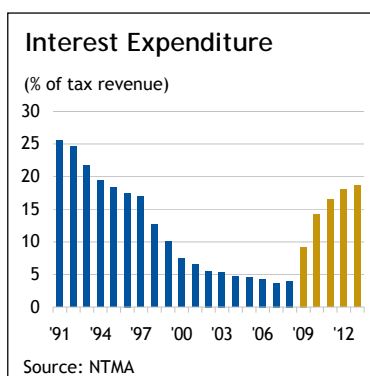
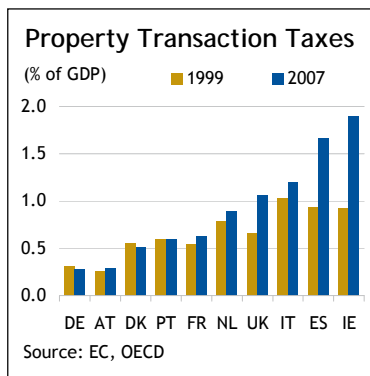
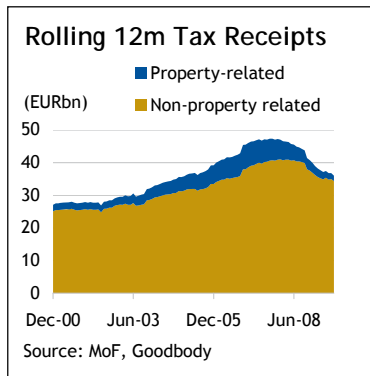
The presence of the International Financial Services Centre (IFSC) somewhat distorts the picture given by the external balance sheet. For example, resident fund managers holding foreign debt securities on behalf of non-residents add to Ireland's gross external fixed-income assets, whereas the corresponding liability appears on the external balance sheet as equity.

**Comparative Analysis: Public Finances**

**Ireland**

	2008					Last 10 years	
	Belgium 'AA+'	Portugal 'AA'	Ireland 'AA-'	Cyprus 'AA-'	Italy 'AA-'	'AA' median	'AAA' median
Budget balance (% GDP)	-1.2	-2.7	-7.3	0.9	-2.7	-0.1	0.6
Primary balance (% GDP)	2.6	0.3	-5.9	3.7	2.4	2.5	2.5
Revenues and grants (% GDP)	48.8	43.2	32.2	44.5	46.0	39.9	43.2
Volatility of revenues/GDP ratio	1.7	3.0	4.0	11.4	2.0	3.6	2.8
Interest payments (% revenue)	7.7	6.9	4.3	6.3	11.2	5.8	5.0
Debt (% revenue)	183.9	153.6	136.9	108.4	229.9	94.1	117.2
Debt (% GDP)	89.7	66.4	44.1	48.2	105.8	45.6	50.6
Net debt (% GDP)	81.9	60.7	18.3	35.3	102.4	35.9	41.9
FC debt (% total debt)	1.4	0.7	0.0	16.0	0.2	6.7	2.5
CG debt maturities (% GDP)	18.5	15.0	3.9	10.8	18.9	10.9	9.2
Average duration of CG debt (years)	4.5	3.8	5.4 <sup>a</sup>	6.6	4.5	3.9	4.8

<sup>a</sup> This figure is net of cash balances  
Source: Fitch



**Strengths**

- Ireland has a track record of debt reduction (successfully lowering the public debt stock from 94.5% in 1991 to 25% in 2007) although this was helped by impressive economic growth and, in latter years, windfall receipts from the property and construction boom.
- The government has established credibility in the face of the fiscal crisis, pushing through difficult consolidation measures. A large cash buffer (15% of GDP in Q309) helps its liquidity position and reduces the net debt ratio.

**Weaknesses**

- Including NAMA liabilities, public debt will reach 111% by 2011 according to Fitch's projections. This is far above the 'AA' median and will take many years and a sustained fiscal policy effort to bring down. Therefore there are significant risks to fiscal sustainability.
- Debt service to revenue will be high relative to peers, even on the expectation that NAMA's income will be sufficient to service its own bonds. The relatively short average duration of the gross government debt stock implies a higher sensitivity to market yields. Given the political consensus to maintain a low tax burden and the sacrosanct nature of the corporation tax rate, the interest burden will reduce fiscal flexibility.
- Revenue volatility has been very high due to an overreliance on property-related receipts, which constituted 17% of the total tax take in 2006 (mostly volatile transaction-based taxes). The collapse in property prices and turnover has caused this share to fall to an estimated 3-4% in 2009. Taxes in the 12m to September 2009 were 24% down on Q406-Q307. Nominal wage cuts have added to the government's revenue woes through poor income tax performance.
- The central government's 2009 gross financing requirement (ie including bond maturities and the end-2008 stock of short-term debt) comes to around 29% of GDP, the largest of any high-grade sovereign. Excluding short-term debt (cash balances are held against this), the figure is 16% of GDP. Having to re-enter the market after a prolonged absence has been expensive for Ireland. Nonetheless, the debt agency has completed its 2009 funding and is now pre-funding 2010.
- Being a small euro area country, Ireland lacks a significant domestic investor base for its debt. Although investor-base diversification offers more attractive borrowing terms in the good times, lack of domestic borrowers offering "home bias" stability has exacerbated adverse shifts in the debt markets against Ireland during the crisis.

**Fiscal Accounts Summary**

% of GDP	2006	2007	2008	2009 <sup>f</sup>	2010 <sup>f</sup>	2011 <sup>f</sup>
<b>General government</b>						
Revenue	35.2	34.3	32.2	31.6	31.0	32.0
Expenditure	32.2	34.1	39.5	44.1	42.9	40.7
o/w interest payments	1.1	1.0	1.2	2.2	3.1	3.8
Primary balance	4.0	1.2	-5.9	-10.3	-8.9	-4.9
Overall balance	3.0	0.2	-7.3	-12.5	-12.0	-8.7
<b>General government debt (Official definition)</b>						
Guaranteed NAMA bonds	-	-	-	-	33.3	31.4
General government debt (Fitch definition)	24.7	24.9	44.1	60.9	109.8	111.4
% of general government revenue	70.1	72.5	136.9	192.3	354.5	348.6
<b>General government deposits</b>						
Net general government debt	10.4	8.8	18.3	42.0	89.0	94.1
<b>Central government</b>						
Revenue	27.1	26.0	23.7	22.2	23.1	24.1
o/w grants	-	-	-	-	-	-
Expenditure and net lending	25.8	26.8	30.7	34.4	35.2	34.4
o/w current expenditure and transfers	20.9	21.5	24.6	27.9	31.0	30.2
- interest	1.1	0.9	0.9	1.9	3.1	3.7
o/w capital expenditure	4.9	5.3	6.1	6.5	4.3	4.2
Current balance	5.1	3.7	-1.7	-6.7	-8.9	-7.1
Primary balance	2.4	0.0	-6.1	-10.4	-9.1	-6.6
Overall balance	1.3	-0.9	-7.0	-12.3	-12.2	-10.3
<b>Gross central government debt</b>						
% of central government revenues	82.6	85.1	168.3	267.4	299.3	308.9
<b>Gross central government debt (EURbn)<sup>a</sup></b>						
By residency of holder	39.7	42.0	72.4	98.3		
Domestic	11.2	7.4	12.8			
Foreign	28.4	34.5	59.6			
By place of issue						
Domestic	39.7	42.0	72.4			
Foreign	0.0	0.0	0.0			
By currency denomination						
Local currency	39.7	42.0	72.4			
Foreign currency <sup>b</sup>	0.0	0.0	0.0			
By maturity						
Less than 12 months (residual maturity) <sup>a</sup>	4.0	10.3	32.6	30.3		
Average maturity (years) <sup>a</sup>	6.6	7.0	4.3	4.2		
<b>Memo: Cash balances (EURbn)<sup>a</sup></b>						
	3.8	4.4	22.0	25.0		
<b>Memo: Nominal GDP (EURbn)</b>						
	177.3	189.8	181.8	165.9	163.7	172.0

<sup>a</sup>2009 figures are Q3

<sup>b</sup>All foreign currency commercial paper borrowing is swapped into EUR

Source: Ministry of Finance, NTMA and Fitch estimates and forecasts

**External Debt and Assets**

(USDbn)	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
<b>Gross external debt</b>	258.1	319.2	410.7	544.3	800.6	1103.7	1267.7	1764.3	2252.5	2352.8
% of GDP	267.5	330.6	392.4	443.4	508.0	596.2	629.3	793.0	867.3	884.4
% of CXR	227.9	257.8	299.0	365.6	466.1	543.9	567.0	689.6	715.2	678.1
<b>By maturity</b>										
Medium- and long-term	42.9	45.5	165.1	222.9	360.6	516.5	671.3	931.1	988.4	1323.6
Short-term	215.2	273.7	245.6	321.4	440.0	587.2	596.3	833.2	1264.2	1029.2
% of total debt	83.4	85.7	59.8	59.1	55.0	53.2	47.0	47.2	56.1	43.7
<b>By debtor</b>										
Monetary authorities	2.0	2.0	3.0	3.9	13.2	9.2	5.5	3.5	1.0	61.8
General government	20.4	21.3	23.5	23.2	29.9	35.0	31.8	35.9	44.4	80.3
o/w central government	15.4	15.9	18.7	22.9	29.8	34.7	31.9	36.0	40.2	57.8
Banks <sup>a</sup>	166.0	188.6	201.5	257.7	378.2	538.4	654.9	889.9	1137.0	1067.2
Other sectors	69.7	107.4	182.7	259.5	379.3	521.1	575.5	835.0	1070.1	1143.6
<b>Gross external assets (non-equity)</b>			634.1	840.2	1192.6	1529.3	1751.0	2248.5	2895.4	2793.5
International reserves, incl. gold	5.4	5.4	5.6	5.5	4.1	2.9	0.9	0.8	0.9	1.0
Other sovereign assets nes	-5.4	-5.4	7.2	6.7	11.3	14.6	16.1	19.9	22.7	13.9
Deposit money banks' foreign assets	154.6	229.4	287.9	387.2	562.1	740.6	831.0	1155.7	1479.0	1421.9
Other sector foreign assets			310.7	419.7	600.0	761.9	883.5	1067.0	1356.6	1356.6
<b>Net external debt</b>	-151.0	-161.4	-223.4	-295.9	-392.1	-425.6	-483.3	-484.2	-642.8	-440.7
% of GDP	-156.4	-167.2	-213.4	-241.1	-248.8	-229.9	-239.9	-217.6	-247.5	-165.6
% of CXR	-133.3	-130.4	-162.7	-198.8	-228.2	-209.8	-216.2	-189.3	-204.1	-127.0
<b>Net sovereign external debt</b>	16.3	17.1	13.6	15.0	27.6	26.7	20.3	18.7	21.8	127.1
% of GDP	16.9	17.7	13.0	12.2	17.5	14.4	10.1	8.4	8.4	47.8
<b>Net bank external debt<sup>a</sup></b>	-0.7	-1.5	-109.0	-150.5	-199.1	-211.6	-195.6	-270.8	-378.1	-354.7
<b>Net other external debt</b>			-128.0	-160.3	-220.7	-240.8	-308.1	-232.0	-286.5	-213.1
<b>Net international investment position</b>			-15.7	-24.6	-35.6	-36.7	-47.2	-3.5	-46.3	-46.3
% of GDP			-15.0	-20.0	-22.6	-19.8	-23.4	-1.6	-17.8	-17.4
<b>Sovereign net foreign assets</b>			-13.6	-10.6	-19.1	-14.8	-6.0	1.2	2.3	-103.1
% of GDP			-13.0	-8.6	-12.1	-8.0	-3.0	0.5	0.9	-38.8
<b>Debt service (principal &amp; interest)</b>	19.2	26.5	48.8	58.2	88.5	125.6	166.5	231.0	295.8	347.1
Debt service (% of CXR)	17.0	21.4	35.5	39.1	51.5	61.9	74.5	90.3	93.9	100.0
Interest (% of CXR)	8.9	14.2	11.5	9.1	9.5	11.0	14.4	18.4	25.0	23.7
<b>Liquidity ratio (%)</b>	90.8	66.2	72.8	96.6	95.8	100.1	98.7	100.5	102.4	91.8
<b>Net sovereign FX debt (% of GDP)</b>	-3.0	-3.6	-3.6	-3.8	-2.6	-1.6	-0.4	-0.4	-0.3	-0.4
<b>Memo:</b>										
Nominal GDP	96.5	96.6	104.7	122.7	157.6	185.1	201.4	222.5	259.7	266.0
<b>Gross sovereign external debt</b>										
Inter-company loans			4.7	6.6	-2.1	-20.7	-54.1	-69.9	-71.2	-80.0

<sup>a</sup> Broad definition of financial institutions (ie including the IFSC). The domestic (ie Irish-owned) banking sector has a net external debt position. Sources: CSO, IMF and Fitch estimates

**Balance of Payments**

(USDbn)	2006	2007	2008	2009 <sup>f</sup>	2010 <sup>f</sup>	2011 <sup>f</sup>
<b>Current account balance</b>	-9.1	-12.7	-12.7	-8.0	0.0	2.2
% of GDP	-4.1	-4.9	-4.8	-3.5	0.0	0.9
% of CXR	-3.6	-4.0	-3.7	-2.5	0.0	0.6
<b>Trade balance</b>	31.9	31.3	38.5	46.5	54.6	56.9
Exports, fob	104.7	115.5	119.6	115.4	118.9	122.5
Imports, fob	72.8	84.2	81.1	69.0	64.3	65.6
<b>Services, net</b>	-9.3	-5.5	-6.9	-10.0	-10.0	-10.0
Services, credit	69.2	89.0	99.3	80.0	90.0	100.0
Services, debit	78.5	94.5	106.2	90.0	100.0	110.0
<b>Income, net</b>	-31.1	-36.9	-42.1	-42.1	-42.1	-42.1
Income, credit	75.3	104.0	120.2	120.2	120.2	120.2
Income, debit	106.4	140.8	162.4	162.4	162.4	162.4
O/w: interest payments	47.1	78.8	82.3	75.0	67.9	61.7
<b>Current transfers, net</b>	-0.5	-1.7	-2.1	-2.3	-2.5	-2.5
<b>Memo:</b>						
Non-debt-creating inflows (net)	71.3	122.1	11.7	39.4	50.0	50.0
o/w equity FDI	-17.9	20.7	-25.6	9.1	19.7	19.7
o/w portfolio equity	86.9	118.0	36.8	30.0	30.0	30.0
o/w other	2.3	-16.6	0.5	0.3	0.3	0.3
Change in reserves (-=increase)	-0.1	0.0	0.2	0.0	0.0	0.0
Gross external financing requirement	193.0	229.7	277.4	222.7	207.8	201.3
Stock of international reserves, incl. gold	0.8	0.9	1.0	0.8	0.8	0.8

Sources: IMF and Fitch estimates and forecasts

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