Fitch Affirms Ireland at ‘AAA’; Outlook Stable

Fitch Ratings–London–20 January 2009: Fitch Ratings has today affirmed the Republic of Ireland’s Long-term foreign currency Issuer Default Rating (IDR) and Short-term foreign currency IDR at ‘AAA’ and ‘F1+’, respectively. At the same time, the agency has affirmed Ireland’s Long-term local currency IDR and Country Ceiling at ‘AAA’, respectively. The Outlooks on the Long-term IDRs are Stable.

“Ireland is in the midst of a deep recession as the economy adjusts to the unwinding of a residential construction boom and the consequent banking crisis and a sharp fall in government tax revenue. Nonetheless, the strong initial starting point of public finances, net government debt is just 29% of GDP, substantially below most ‘AAA’-ranked peers such as the UK, and economic fundamentals provide Ireland with the ability to withstand this stress and maintain its ‘AAA’ status. However, this is also dependent on the government remaining committed to fiscal consolidation over the medium-term and the fiscal costs of financial sector support not exceeding current expectations,” said Chris Pryce, Director in Fitch’s Sovereigns Group.

Ireland’s GDP grew by 6% in 2007, but declined by over 1% in 2008 and Fitch now expects growth to fall by 4% this year, not recovering until late 2010 or 2011. The decline in residential output and house prices began in 2007, but the severity of the fall did not become apparent until 2008 when the number of new houses built fell from almost 90,000 to 50,000 in just two years and will fall to or below 30,000 this year. House prices have been falling consistently since the spring of 2007. The twin falls in both transactions and asset values has had a significant impact on tax revenue, which fell by 14% (over EUR6bn, equivalent to 3.4% of GDP) and is projected to decline by a further 9% (EUR4bn) this year.

The central government’s deficit widened from under 1% of GDP in 2007 to almost 7% in 2008 and the government projects that without policy changes, the budget deficit would rise to 11% this year and oscillate in the 12-13% range every year for the following four years. The government has announced in its January 2009 ‘Addendum to the 2008 Stability Programme Update’ fiscal ‘adjustments’ to reduce the projected deficit by EUR2bn in 2009 and between EUR3bn and EUR4bn in each of the next four years, amounting in total to EUR16.5bn. Each annual adjustment will consist of a yet unannounced combination of tax measures, including base broadening and rate increases, and expenditure cuts.

“The government’s public commitment to these targets, its willingness to be clear regarding the potential economic pain its plans will cause and its acceptance of the consequent electoral unpopularity are essential to its credibility,” said Chris Pryce. The government is expected to announce by the end of February the composition of the first EUR1bn in adjustments and further specify the next EUR1bn shortly thereafter, while the 2010 Budget in the autumn will detail a further EUR4bn of deficit-reducing measures.

The impact of these measures will not prevent, according to government forecasts, general government debt rising above a 60% of GDP limit by the end of 2010, but it will probably keep it below 70% of GDP which Fitch expects to be the level reached or just exceeded by a number of European ‘AAA’-rated sovereigns. Fitch takes note of the considerable ‘cash or liquid’ assets in government hands (about 12% of GDP) which reduces the government’s indebtedness in net terms at end 2008 from 41% of GDP gross to 29%. No other ‘AAA’-rated sovereign has such comparably large cash balances. The accumulation of these assets, mostly in 2008, means that the rise in gross debt also overstates the deterioration in underlying fiscal health in that year. Ireland’s National Pension Reserve Fund, currently valued at some 9% of GDP, which is subject to government control could also be used to reduce government debt on a net basis (to potentially 20% at end 2008). However, the government has already announced that part of these assets will be used to fund the recapitalisation of the Irish banks.

The banks pose another major challenge to the government. As a result of the property boom for which they provided much of the finance, the banks are now facing a steady rise in non-performing loans. The government has attempted to deal with one aspect of the problem by issuing a sovereign guarantee for deposits and most other bank liabilities. The government has also accepted that it will have to contribute to bank recapitalisation either by buying preference shares or by underwriting share issues.

The government has also announced in recent days that it will nationalise the third largest lender, Anglo Irish, for an as yet to be established amount, but certainly less than the sum it would have spent recapitalising it. The government has said it will put up to EUR10bn into recapitalising banks. It has so far committed about half this amount, and the ultimate fiscal cost of support for the banking sector could be much greater.

Though bank debt and deposits guaranteed by the Irish government exceed 230% of GDP, the guarantee has reassured investors and depositors that no individual financial institution will be allowed to fail, while the risk of a simultaneous system-wide collapse is very remote. Consequently, Irish banks continue to have access to market funding as well as to the European Central Bank's liquidity facilities. The ultimate fiscal costs of restoring Ireland's banks to financial health will prove substantial, but current estimates do not suggest that they will be great enough to imperil Ireland's 'AAA' status.

Another uncertainty has been the funding challenges faced by a number of EU governments. Fitch notes that the Irish government secured five year funding of EUR6bn last week, albeit at elevated pricing levels. It also accumulated as a matter of policy over the past year cash balances of more than EUR20bn and in Fitch's opinion the risk of a 'fiscal funding' crisis is very low.

Ireland continues to enjoy many of the benefits which brought it economic success in the past. These include a high income per head, a flexible and skilled labour force assisted by strong immigration and rising female participation, a business friendly and open economy including an advantageous corporate taxation regime, and a tradition of encouraging foreign investment. It has also established a strong political consensus on the importance of encouraging business at home and abroad and the need for fiscal consolidation.

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