

Rossa White

rossa.white@davy.ie +353 1 6148770

Stephen Lyons

stephen.lyons@davy.ie +353 1 6149903



Davy Research

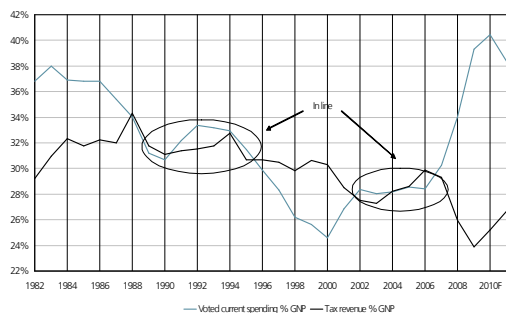
April 7, 2009

Research Report: Irish economy

Supplementary Budget 2009

Bank plan is positive, but the reliance on tax for fiscal adjustment is not

Voted current spending and tax revenue (% of GNP)



Government announces proposal for Asset Management Company (AMC) to cleanse bank balance sheets

- The desired outcome of the AMC is that cleansed banks may increase the credit flow to the economy.
- Assets will be transferred to the AMC at an "appropriate price": banks/creditors will not get off lightly.
- This announcement signals little appetite for nationalisation. The agency structure may ensure survival of salient banks and reduce perceived sovereign risk.

Three-year fiscal plan: deficit target of 8.5% in 2011

- The government has produced a detailed fiscal plan for 2009-2011. It outlines the mix of tax increases and spending cuts required to reduce the General Government Deficit over the next three years.
- The government has avoided an aggressive response in 2009, acknowledging weakness of the economy. It aims to close the deficit to 10.75% of GDP from an estimated 12.75% pre-Budget.
- Crucially, it targets a deficit peak in 2009 before a steady fall to €15bn, or 8.5% of GDP, by 2011.

Reliance on tax hikes and capital spending cuts far from ideal; current spending at record share of economy

- The targets are helpful, but the means to attain them is not. The fiscal measures veer towards tax hikes and capital spending cuts rather than reductions in the cost base of the public service. Current spending is set to reach a record share of 40% of GNP in 2010.
- Income tax hikes range between 3.5% and 5.5% in 2009 for workers on average income.
- The capital spending cuts are puzzling. Investors will finance public investment because it boosts productivity and is the easiest way to keep people in employment.

Please refer to important disclosures at the end of this report.

Davy is regulated by the Financial Regulator and is a member of the Irish Stock Exchange and London Stock Exchange. Davy is authorised by the Irish Financial Regulator and regulated by the Financial Services Authority for the conduct of business in the UK. All prices as of close of previous trading day unless otherwise indicated. All authors are Research Analysts unless otherwise stated. For the attention of US clients of Davy Securities, this third-party research report has been produced by our affiliate, J & E Davy.

Deficit of 8.5% of GDP targeted by 2011 based on plan for next three years

- The main plus point of the Budget is that the government outlined a plan to reduce the deficit over the next three years

The main plus point of the Budget is that the government outlined a plan to reduce the deficit over the next three years. It has targeted a General Government Deficit of 10.75% of GDP this year, some two percentage points lower than the pre-Budget estimate. By 2011, it envisages closing that gap to 8.5%. It also did not try to be too ambitious in 2009, keeping in mind that the economy was set to shrink by at least 7% anyway before today's measures were outlined.

The banking plan is hugely welcome and along the lines that we had hoped for (see Page 7 and the separate research note to be issued later this morning). It will be a crucial step towards reigniting credit flow in a country where monetary dynamics have been worrying.

- But the disappointing aspect of the Budget was that it did not have any real vision for the future

But the disappointing aspect of the Budget was that it did not have any real vision for the future. Ireland has to return to the late-1990s model, which was based on exports. To do that, reducing the cost base of the state is imperative. This Budget focused far too much on tax hikes and cuts in capital spending and not enough on reducing the public cost base, especially pay and pensions. Moreover, the tax increases were skewed almost exclusively towards labour.

We have stressed repeatedly that successful fiscal consolidations weight the adjustment towards current (not capital) expenditure rather than tax. That was the lesson from Ireland's 1980s experience and results mainly from the second-round boost to competitiveness – this is especially important in an economy like ours that is so reliant on trade. Note, too, that Ireland's greatest advantage is its demographics: it has the highest proportion of graduates in the 25- to 34-year age cohort in the EU (with the exception of Cyprus). These graduates will be hit by significant tax hikes, averaging at least 3.5% of disposable income (see Table 1).

Summary of main Supplementary Budget measures

- The government proposed the establishment of an AMC to deal with impaired property assets (mainly focusing on development) in the banking system.
- The income levy is now 2% on income up to €75,036, 4% in excess of that up to €174,890 and 6% in excess of that mark. Those earning less than €15,028 will be exempt.
- The health levy will double to 4% up to €75,036 and will become 5% above that. Those earning less than €26,000 will be exempt.
- The PRSI ceiling will be increased to €75,036 from €52,000.
- These changes together will hit disposable income by €1.3bn, or 1.4% of after-tax income, in 2009.
- The capital spending budget was cut sharply, particularly in 2010.
- Current spending cuts totalled about half of the gross tax increases in 2009 (i.e. before the impact of negative buoyancy on tax).

- The government now expects GNP to drop 8% in real terms this year

- The government has introduced an early retirement scheme for public servants aged over 50. This will not affect their actuarial pension entitlement.
- The Capital Gains Tax (CGT) rate was raised to 25% from 22%.
- A stamp duty "trade-in" scheme is set to be unveiled in the Finance Bill (more detail is required).
- An Enterprise Stabilisation Fund will be set up. It will have a total budget of €100m over two years.

Forecasts are pretty realistic, although CPI may fall again in 2010

Official forecasts for the economy for the next two years do not deviate too much from our own. The government now expects GNP to drop 8% in real terms this year. In its pre-Budget submission last week, it projected that GNP would fall 7% in 2009. As a result, it estimates that the hit from the Budget (adjustments of €3.3bn) may actually reduce economic activity by only about half of that or one percentage point of GNP. That is probably a little optimistic as it implies that the income tax and PRSI hikes will largely be absorbed through lower savings (it is true that the savings ratio has already spiked over the past year).

Table 1: Impact of tax changes on income for those on earnings of €40,000

Example	Description	Loss as % of net income
1	Married couple, one income, no children taxed under PAYE Full rate PRSI contributors	-3.40%
2	Married couple, one income, two children (under the age of 5) taxed under PAYE Full rate PRSI contributors	-5.30%
3	Married couple, two incomes, no children taxed under PAYE Full rate PRSI contributors	-0.70%
4	Single person taxed under PAYE Full rate PRSI contributors	-3.70%
5	Married couple, one income, no children Taxed under Schedule D	-3.60%
6	Married couple, one income, two children (under the age of 5) Taxed under Schedule D	-5.50%
7	Married couple, two incomes, no children Taxed under Schedule D	-0.80%
8	Single person taxed under Schedule D	-3.90%

Source: Department of Finance

For 2010, its GNP volume forecast of -2.8% is similar to our pre-Budget projection (we anticipated -7% in real terms in 2009 and -4% in 2010), taking the lower 2009 base into account. But we had not yet factored in the deflationary effect of this Budget in 2010. We would quibble more with the forecast for the CPI in 2010. It may decline by another 2% rather than increase by 0.3%. That has implications for tax revenue.

Three-year plan welcome, but reliance on tax hikes and capital spending cuts is far from ideal

The government has targeted a deficit of 10.75% this year. That compares with a pre-Budget estimate of 12.75%. This year's package included almost €900m in extra current spending cuts; €575m off the capital programme; €800m in extra employee social welfare contributions; and €430m in net extra tax (taking into account the negative buoyancy from the tax increases and spending cuts announced).

It wisely chose not to attempt to close the deficit by any more than two percentage points of GDP because the economy is already deep in recession. Households, in particular, have increased savings substantially in the face of a rapidly weakening labour market.

A three-year plan, detailing the tax hikes and spending cuts to come, was also unveiled. The plan envisages a deficit of 8.5% of GDP in 2011. The detail is welcome, but the balance of tax and spending certainly is not (see Table 2).

Tax and capital spending cuts clearly account for the bulk of the adjustment. Taxes are set to rise by a net €5bn+, or 3.5% of GNP, over the next 32 months. The low tax wedge on labour has been a key plank of Ireland's competitive business environment over the last decade, yet this Budget fails to take cognisance of that fact.

- A three-year plan was also unveiled, envisaging a deficit of 8.5% of GDP in 2011
- Tax and capital spending cuts clearly account for the bulk of the adjustment

Table 2: Three-year fiscal plan (€m)

	2009	2010	2011	Pre-Budget 2009 level	Savings vs. Pre- Budget 2009 level
Net tax hikes	430	1750	2250	33970	13.0%
PRSI	799	N/A	N/A		
Voted current spending	-886	-1500	-1500	57473	-6.8%
of which:					
Social welfare	-300	-58	-718	21571	-5.0%
Non-social welfare	-586	-1442	-782	35902	-7.8%
Voted capital	-576	-750	-1000	7905	-29.4%
Total annual fiscal measures	2691	4000	4750		
GDP (nominal)	171500	167100	174800		
Fiscal measures % GDP	1.6%	2.4%	2.7%		
Targeted GGB % GDP	10.75%	10.75%	8.50%		

Source: Department of Finance

- Capital spending will be reduced by over €2.25bn, or 29%, compared with the pre-Supplementary Budget base

Capital spending will be reduced by over €2.25bn, or 29%, compared with the pre-Supplementary Budget base. Some of this will be offset by deflation in the building sector, implying that volume will fall less than value. But that is little consolation to a construction sector on its knees: housing starts are at about 6,000-7,000 annualised (or a level commensurate only with replacing obsolete stock), and private non-

residential building is shrinking quickly. It seems bizarre to cut capital spending so aggressively in that context. But there are further considerations:

- Bond investors would happily pay for capital spending as it guarantees a higher level of tax revenue into the future by boosting productivity: if the government feared borrowing to invest, that fear is misplaced.
- If that is the case, we do not understand why the European Investment Bank has not been explored as a funding option.
- Building programmes are the quickest way to put people to work (many other countries are ramping up spending on infrastructure), so why slash them?

Table 3: Voted capital spending (€m)

	2009	2010	2011	2012	2013
Before Budget	7905	8297	8193	9672	9160
After Budget	7329	6621	5491	6000	6000
Cut	-576	-1676	-2702	-3672	-3160

Source: Department of Finance

Current spending is set to be trimmed by less than €4bn in 2009-2011. Interestingly, social welfare reduction will account for half of the cut in 2011. Does that mean the rate will be decreased after CPI drops significantly in 2009 and 2010?

Current spending, especially pay, must be tackled

We think much more has to be done on current spending, especially on the public pay bill. The structural overshoot in current spending is about €8bn on our estimates. Note that voted current spending (i.e. excluding interest payments on the National debt) is set to reach a record 39.3% of GNP this year, even taking into account the small reductions announced in 2009 (see Figure 1). The public pay bill, which has doubled to €20bn in the last eight years, must be tackled. We advocated a "Benchmarking III" exercise. This will finally correct the 20%+ pay premium enjoyed by the public sector, controlling for education, experience etc as found by the ESRI in its report in December 2008. Remember that those calculations were based on 2006 data and do not take into account generous awards since or the recent deep cuts in private sector wages.

We are, however, encouraged by the Minister's comments on the three-year plan: "I want to stress that the expenditure figures are the minimum that must be achieved and the figures mentioned for tax are the very maximum that can be imposed". We hope that any further spending cuts are focused on pay and numbers in the public service and certainly not on capital spending.

• Much more has to be done on current spending, especially on the public pay bill

• We hope that any further spending cuts are focused on pay and numbers in the public service and certainly not on capital spending

Figure 1: Voted current spending and tax revenue (% of GNP)



Source: Department of Finance

It is also worth noting that two review groups have yet to report. Colm McCarthy's Special Group on Public Service Numbers and Expenditure Programmes will detail the efficiencies to be driven across public services and will also report on payroll levels. Numbers employed must also be on the table: the recently announced ban on public sector recruitment is not enough. Meanwhile, the Commission on Taxation will report in July. The Budget makes it clear that property and carbon taxes are on the way. That is good news as further tax hikes must be kept away from labour.

- The fiscal measures announced are not enough to bring the deficit down to 10.75% this year

Rinky-dink under Eurostat rules used to partly close the deficit

The fiscal measures announced are not enough to bring the deficit down to 10.75% this year. The €2.7bn in net savings leaves a shortfall of about €1bn. Likewise, it would be difficult to keep the deficit at 10.75% of GDP next year, based on the mix of tax and spending policies outlined. So the government has turned to an accounting trick that provides an optical improvement this year and next under Eurostat's General Government Deficit rules.

The Exchequer is absorbing the pension fund assets and liabilities of universities and certain non-commercial state agencies. The €1.7bn in assets in these funds will improve the general government balance when received. The National Treasury Management Agency (NTMA) will manage the funds. But the initial revenue and investment return will be offset when pension benefits are paid out: that will count as government expenditure, hence affecting the General Government balance.

National Pensions Reserve Fund has not yet been set aside for bank re-cap: this is vital to reduce potential borrowing requirement

We expected some announcement that the National Pensions Reserve Fund (NPRF) would be fully committed to the bank re-cap programme. This would have ideally accompanied the proposal to set up the AMC.

- **The €7bn preference share injection to Allied Irish Banks and Bank of Ireland should have come directly from the NPRF**

As we have noted before, the €7bn preference share injection to Allied Irish Banks and Bank of Ireland was financed with €4bn from the NPRF and €3bn in borrowing. In our view, the €7bn should have come directly from the NPRF, saving an easy €3bn in bond issuance. Further funds for re-cap, if required, could come from the NPRF: for example, if capital is needed when write-downs crystallise on the transfer of assets from the banks to the AMC. A clear statement in this regard, committing the whole NPRF to the banking problem (whether it is ultimately needed or not), would be helpful to potential international investors in Irish government debt.

Asset management agency to acquire development loans

€80-90bn of assets to be transferred; stronger bank balance sheets will ensure an orderly flow of credit in the economy

- **The government is to establish a National Asset Management Agency (NAMA) to deal with the banks' problematic land and property development assets**

The government is to establish a National Asset Management Agency (NAMA) to deal with the banks' problematic land and property development assets. The NAMA, which will be supported by the NTMA, is to purchase these assets and actively manage the loan book to ensure optimal value for money for taxpayers. The guided value of loans is €80-90bn, but the final figure will be based on a detailed assessment of the loan books and will be lower due to the haircut taken on transfer. The desired outcome is for a clean bill of health for the banks, which will have stronger balance sheets as a result of reduced uncertainty over bad debts. This will ensure an orderly flow of credit in the economy.

- **The desired outcome is for a clean bill of health for the banks, which will have stronger balance sheets as a result of reduced uncertainty over bad debts**

Agency to be operated independently

This agency will be operated on a commercial and independent basis, and legislation is expected before the summer. The agency's sole purpose will be that of an AMC. It will not operate as a bank receiving deposits and will not seek a banking licence. The set-up of the agency and the terms of transfer of the assets will need to comply with the EU guidelines for state aid issued in February. The outline is at pains to mention that the loans will be purchased at an "appropriate price" and that banks will not get off lightly. In the event that assets transferred to the NAMA do not cover the government's investment, a levy will be put in place to recoup the shortfall. The outline also indicates that creditors will not get off lightly either as the agency will have the full benefit of cross-collateralisations and personal guarantees on existing loan contracts to recover debt.

Write-downs on transferred loans to be offset by a reduction in risk-weighted assets

It is acknowledged that the transfer of loans at a discount to book value will see the banks incur a loss. However, the hit to capital will be offset by a reduction in risk-weighted assets. The commercial loans will be replaced by government bonds with a zero risk weighting, which will be used by the agency to acquire the loans. We understand that these bonds will not require funding from debt markets but will take the form of an IOU with the participating banks. In the event that the crystallisation of losses leaves a participating institution with a capital shortfall, the state will insist on participation by way of ordinary shares in the relevant

- The role of the Central Bank is to be reformed to place it at the centre of financial supervision and financial stability oversight

institution. It is expected that banks will be willing participants in the scheme, but legislation will be forthcoming that will give the agency mandatory power to acquire bank assets if necessary.

Anglo Irish Bank to continue as a going concern; state guarantee to be extended to support debt issuances of up to five years

Separately, the statement details that Anglo Irish Bank is not to be run as a bad bank and will continue to be operated as a going concern on an arm's length basis. It is also the intention to put a state guarantee in place for debt issuance with a maturity of up to five years. The role of the Central Bank is to be reformed to place it at the centre of financial supervision and financial stability oversight.

Agency structure will allow these banks to survive; government has little appetite for nationalisation

The announcement of the new agency is a clear positive in the sense that it indicates that the government has little appetite for nationalisation of the banks and that the NAMA structure should now ensure the banks' survival. In addition, in the event of a future levy from the government, we take comfort from the 20-year time-frame put in place following the failure of the Insurance Corporation of Ireland (ICI) in the 1980s. These banks are looking investable again as they should return to profitability and hopefully sustain the recent share price rally.

Important disclosures

Analyst Certification

Each research analyst primarily responsible for the content of this research report certifies that : (1) the views expressed in this research report accurately reflect his or her personal views about any or all of the subject securities or issuers referred to in this report and (2) no part of his or her compensation was, is, or will be, directly or indirectly related to the specific recommendations or views expressed in this report.

Regulatory and other important information

Davy is regulated by the Financial Regulator and is a member of the Irish Stock Exchange and London Stock Exchange. Davy is authorised by the Irish Financial Regulator and regulated by the Financial Services Authority for the conduct of business in the UK. No part of this document is to be reproduced without our written permission. This publication is solely for information purposes and does not constitute an offer or solicitation to buy or sell securities. This document does not constitute investment advice and has been prepared without regard to the individual financial circumstances and objectives of persons who receive it. The securities/strategy discussed in this report may not be suitable or appropriate for all investors. The value of investments can fall as well as rise and there is no guarantee that investors will receive back their capital invested. Past performance and simulated performance is not a reliable guide to future performance. Projected returns are estimates only and are not a reliable guide to the future performance of this investment. Forecasted returns depend on assumptions that involve subjective judgment and on analysis that may or may not be correct. Any information related to the tax status of the securities discussed herein is not intended to provide tax advice or to be used as tax advice. You should consult your tax adviser about the rules that apply in your individual circumstances.

This document has been prepared and issued by Davy on the basis of publicly available information, internally developed data and other sources believed to be reliable. Whilst all reasonable care has been taken in the preparation of this document, we do not guarantee the accuracy or completeness of the information contained herein. Any opinion expressed (including estimates and forecasts) may be subject to change without notice. We or any of our connected or affiliated companies or their employees may have a position in any of the securities or may have provided, within the last twelve months, significant advice or investment services in relation to any of the securities or related investments referred to in this document.

Conflicts of interest

Our conflicts of interest management policy is available at www.davy.ie/ConflictsOfInterest.

US Securities Exchange Act, 1934

This report is only distributed in the US to major institutional investors as defined by S15a-6 of the Securities Exchange Act, 1934 as amended. By accepting this report, a US recipient warrants that it is a major institutional investor as defined and shall not distribute or provide this report or any part thereof, to any other person.

Distribution of research to clients of Davy Securities in the US

Davy Securities distributes third-party research produced by its affiliate, J & E Davy.

Davy Securities is a member of FINRA and SIPC and is regulated by the Financial Regulator.

Confidentiality and copyright statement

Davy, Research Department, Davy House, 49 Dawson St., Dublin 2, Ireland.

Confidential © Davy 2009.