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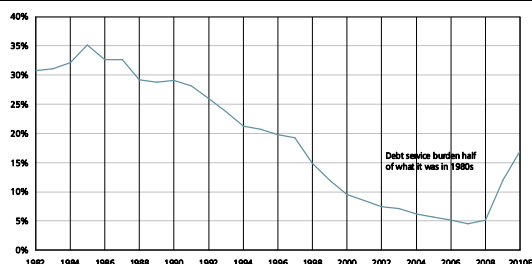
January 21, 2009

Research Report: Irish economy

Irish government finances

State still has lots of options despite recent hysteria

Government debt service cost % of tax revenue



Anglo Irish Bank is not on the government's balance sheet

- Anglo Irish Bank is now a commercial semi-state company. This is crucial from an EU/Maastricht perspective: it means the bank is not on the Irish government's balance sheet.
- As a result, the gross debt (and by extension the debt to GDP ratio) of the Irish government is unaffected by the nationalisation of Anglo at this point in time.
- Of course, any future capital injections into Anglo or other funds required to meet losses with recourse to borrowing would raise gross government debt.

Potential banking losses are creating government funding concerns, but the government has bought time and has plenty of options

- Irish government bonds have fallen in price in recent months as the market questions whether the state can meet the ultimate losses from the banking system's troubled property and business loans.
- Ireland's gilts are now yielding 230 basis points more than German bunds, and its credit default swaps are trading even wider than the cash spreads.
- But the government has many options: it built up a €20bn cash balance (11.5% of GDP) at end-2008 and issued a €6bn bond on January 8th 2009. The National Pensions Reserve Fund (NPRF) can be liquidated to raise a further €15bn and public spending can be cut.

Low initial debt means ability to pay not an imminent issue

- Note that the state started from a good position: the debt to GDP ratio was 41% at end-2008 (or 32% excluding the assets of the NPRF). Nominal yields are still low. As a result, the share of tax revenue required to meet debt repayments will be way lower than in the 1980s, taking into account massive deficits in 2009 and 2010.

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Anglo Irish Bank is not on the government's balance sheet: its nationalisation does not raise Irish gross debt at this point in time

- The nationalisation of Anglo is off-balance sheet: it does not raise Irish gross government debt

Anglo Irish Bank is now a commercial semi-state company like the Electricity Supply Board (ESB) and Bord Gais. This means that it is not part of General Government (all arms of the state except commercial companies with majority state control), which is the crucial variable from the EU point of view under the Maastricht treaty. So, as it stands today, the nationalisation of Anglo does not increase the gross General Government debt of the country and the debt/GDP ratio.

Note that there are lots of EU statistical nuances regarding how Anglo may affect the government's balance sheet and annual deficit over time. If, in the future, it was decided by Eurostat (the EU's statistical body) that it is not (no longer) a commercial entity and was actually part of the General Government sector, all of Anglo's liabilities (i.e. deposits and senior/subordinated debt) would then count towards Ireland's government debt – doubling it at a stroke. Under the rules, netting off its assets would not be allowed as it is *gross* debt (not net debt) that counts from a Maastricht perspective.

It is hard to judge at what point the EU could decide that Anglo is no longer “commercial”. The EU will introduce more rules for this across Europe in a paper shortly: Northern Rock was the test case. But if Anglo morphs into a management company for troubled assets, its designation may well change.

Depending on write-offs and capital injections, Anglo may yet raise the government's debt level

- Capital injections would count as expenditure and raise the General Government deficit, unless seen by the EU as an “investment”

Even if it stays off the government's balance sheet, Anglo could of course affect either the General Government deficit or the gross debt of the country in other ways. Capital injections or debt write-offs would raise the deficit because it would be counted as government expenditure. There is only one exception: a capital injection seen as an investment would be considered a financial transaction rather than government expenditure. Unfortunately, this may not pass the test in Anglo's case.

Gross debt would also rise if this expenditure (capital injection, funds to meet losses) has to be borrowed through government bond issuance. But we could avoid lifting gross debt by tapping the National Pensions Reserve Fund (NPRF).

Total long-term funding needs (excluding funds for bank recapitalisation) for 2009 total about €20bn after successful five-year bond auction

Ireland is going to run a significant fiscal deficit in 2009 and 2010. From the EU's perspective, it is the General Government deficit that matters. It is likely to reach at least €21bn both this year and next. A five-year government bond is also due to be redeemed in April. In total, therefore, long-term funding needs heading into 2009 totalled about

- Ireland had the most successful bond issue in euro area history two weeks ago

€26bn for the calendar year – excluding any funds needed for bank recapitalisation.

Importantly, the National Treasury Management Agency (NTMA, the Irish government's debt manager) successfully raised €6bn in five-year money on January 8th. It was the biggest auction in the history of the euro area. The yield was low in absolute terms at 4.06%.

The salient point is that almost 25% of the year's long-term funding was sorted within the first week of the year. That was an important achievement, considering a failed German bund auction the previous day and in the context of unprecedented government bond issuance in the euro area slated for 2009.

Clearly, potential funding needs for the next number of years may increase depending on future developments or policy decisions made with regard to the Irish banking system. As some sort of (but by no means definitive) guide to Irish prospects, Table 1 provides some sensitivity analysis of the cost of recapitalising banks in Sweden and Finland after their property crash in the early 1990s.

Table 1: Irish banking crisis costs based on Scandinavian 1990s experience

	<i>Finland</i>	<i>Sweden</i>	<i>Norway</i>
Recapitalisation cost (gross, as % of GDP)	8.6	1.9	2.6
Applied to 2008 Irish nominal GDP (€bn)* **	€16.1	€3.5	€4.9

* Current capital position is weaker entering this downturn due to lower equity levels.

** IFRS exclusion of general provisions further weakens banks' loss absorption capacities.

Source: International Monetary Fund; Davy

Irish government has lots of leeway and many options: solvency crisis is a low probability event

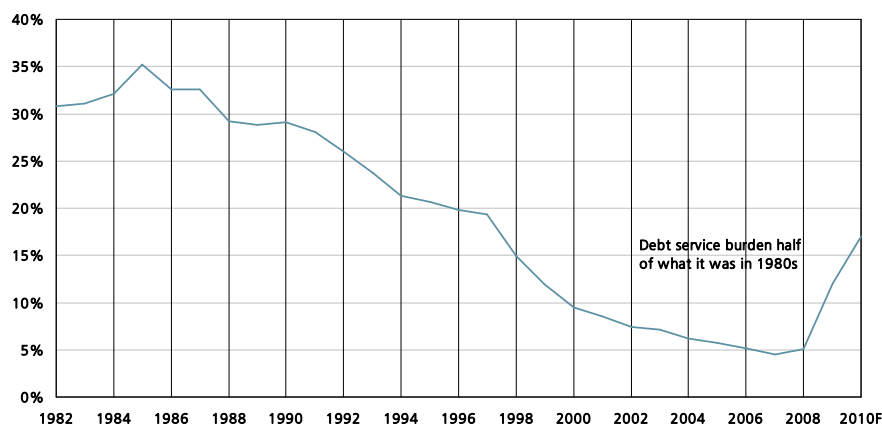
Fortunately, Ireland's government debt was low coming into this recession and banking crisis. At the end of 2008, gross government debt stood at €76.3bn – a debt to GDP ratio of 41%.

But that exaggerates the debt burden at the end of last year. It included €20bn in cash, financed by commercial paper issuance in the second half of 2008. That means the government has bought itself a lot of leeway with its cash cushion heading into 2009. It means that it can easily meet any funding needs caused by unforeseen events or a sudden crisis.

- The government debt repayment burden will still be much lower than in the 1980s, taking into account massive deficits in 2009 and 2010

The risk of Ireland not being able to meet ongoing debt repayments over the next few years is very low. Note here that the share of tax revenue accounted for by debt service is far lower than during the crisis period in the late 1980s. In 1985, debt service accounted for 35.2% of tax revenue. But, as we noted above, the starting position is better this time. The absolute debt level is lower and, moreover, nominal interest rates (bond yields) are nowhere near as high as they were 25 years ago. This year the share of tax revenue taken up by government debt service will be 12-15%, rising to at least 17-20% in 2010 (including some leeway for banking hits).

Figure 1: Government debt service cost as % of tax revenue



Source: Department of Finance; Davy

- The Irish government has lots of cash-raising options in the event of major short-term requirements, including liquidation of pensions fund and deep spending cuts

But the market seems less worried by day-to-day interest repayments and more by the ability to raise significant funds in one chunk to meet losses from the banking system. In this context, the Irish government has plenty of options:

- The most favourable solution is that normal funding continues via government bond issuance. Note that the absolute level of five-year Irish bond yields (at 4.45%) are where they were five months ago, despite the widening spread between Ireland and Germany, due to the rally in bond markets. If Ireland has to pay a premium over the next few years, so be it. The government may well attempt to pre-fund significantly in the first half of 2009 on top of the cash already raised last year.
- Alternatively, the NTMA can make further use of its commercial paper programme (maturity of up to one year), with capacity to increase the current €20bn outstanding. Issuer yield levels are exceptionally low (1.5%), and investor demand remains firm as cash hoarding predominates.
- It can liquidate the NPRF. This contained about €15bn in liquid assets at the end of 2008 (the rest is private equity/property). Ultimately, the fund was Ireland's only counter-cyclical policy measure during the boom years. The government added 1% of GNP per annum to the NPRF. The fund can easily be used in current circumstances to relieve any potential funding stress (albeit that it is likely to be hard to realise €15bn if assets are sold quickly while equity markets remain weak).
- Note that the government has still budgeted for 1% of GNP to be put into the fund out to 2013. That commitment should be waived temporarily, providing €1.5bn in extra cash over the next couple of years.

- Public sector pay cuts can generate significant savings. Given the economic crisis facing the country, everything must be on the table. If the pay bill is cut by 10%, it would generate €2bn in savings. However, it is also necessary to look at the pensions issue.
- Ultimately, the tax base was hollowed out in recent years. The system became too dependent on expenditure/transaction taxes. As a result, tax revenue has dropped much more quickly than nominal GNP. If circumstances become much more difficult, taxes could be raised. But we would not advise this course of action as it would greatly exacerbate the recession and damage Ireland's competitiveness.
- Many forget that the country is set to spend at least €8bn (5%+ of GNP) on capital projects each year until 2013. This year's deficit would be only 7% of GDP rather than 11.5% if infrastructure projects were shelved entirely. We would only advocate cutting the infrastructure programme as a last resort because Ireland's future productivity and living standards are at stake. But it is another option: the long term is tomorrow in current financial markets.

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