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Research Report: Irish economy

The Irish economy

Charting the course to Irish economic and financial stability

A collective response is needed

- The issues facing the Irish economy and Irish society have never been more challenging, and more than ever a collective response is required.
- We, Ireland's three largest stockbrokers, have put aside our competitive instincts to make a common proposal for addressing our national difficulties.

Clear and focused action on public finances and banking system required; competitiveness must be restored

- We have broken down the challenges into four distinct areas: the public finances, the economy, the sovereign debt markets and the banking system.
- International investors need to see that Ireland has a comprehensive, credible, multi-year plan to tackle the emerging deficit in our public finances, to place our banking sector on a sound footing, to transform the funding outlook and to support our economy.
- That will require clear and focussed action on both expenditure and revenue, as well as measures to deal with the underperforming loan assets in the banking system and its capital requirements.
- We must also ensure that competitiveness is restored to the level that brought such rewards in the second half of the 1990s.

Funding conditions will improve with credible fiscal plan

- Irish solvency risks have been wildly exaggerated this year, leading to an increase in the cost of funding.
- A credible plan for fiscal consolidation and repair of the banking system will lead to a reduction of perceived risk and improve funding potential.

Charting the course to Irish economic and financial stability

Collective responsibility is necessary if Ireland is to navigate a way out of its current malaise. This report, authored jointly by Ireland's three largest stockbrokers, addresses two issues. First, it aims to bring clarity and accuracy to the current 'conventional wisdom' in circulation both domestically and internationally, which is in some instances grossly misleading. Second, it may be difficult, but in our view charting a return to economic growth in the medium term is achievable.

Four key challenges

We have broken down the challenges into four distinct areas: the public finances, the economy, sovereign debt markets and the banking system. We have analysed these issues in detail and provide here a number of policy recommendations.

Need for political and social cohesion

Some of the decisions that will need to be taken over the coming years are likely to be considered unpalatable at this stage and, without social cohesion, it is unlikely that they can occur. Previous fiscal consolidations have only been successful with full buy-in by all sections of society, ensuring that any actions have not overly focused on specific social groups.

Political differences must be put aside

The joining of three competitors in this context reflects our shared view that the way forward in this period of unprecedented economic stress in Ireland is an open debate. We therefore propose the sharing of ideas, possible solutions and responsibility in public policy decisions. The government and opposition must put aside political differences in the national interest.

The public finances

Budget deficits of over 10% of GDP will emerge in the absence of any policy action out to 2013. The sustainability of the Irish economy must be based on stable public finances.

Multi-annual fiscal plans required

Instead of simply focusing on short-term changes to tax and expenditure plans in the upcoming Budget, focus should be placed on setting strict targets over a multi-year period. These targets must be transparent, and it must be easy to verify that they have been met. Individual departments must be held to account for failing to adhere to agreed spending limits.

Current expenditure must bear the brunt of the adjustment

Previous episodes of fiscal adjustment suggest that policies that focus on expenditure cuts rather than tax increases have a better chance of success. While politically more difficult, this principle must be adhered to. Voted current spending is currently headed towards a record level as a percentage of national income in 2009. Given that output in the economy is dropping back to 2005 levels, Ireland should aim to reduce voted current spending (excluding the automatic stabiliser of the higher numbers of social welfare recipients) and raise the structural level of taxes to the same percentage of GNP as pertained in that year.

Difficult decisions on the public sector and benchmarking cannot be avoided

The public sector plays an important role in the economy and should be rewarded accordingly. However, developments in the private sector, where job and pay cuts have been widespread, mean that the resources are no longer available to support a public service at its current size. We must dispel the view that the focus on a reduction in the size of the public sector pay bill is a witch-hunt but rather a reflection of a changed labour market environment. Fast-tracking the National Employment Survey, or at the very least the quarterly establishment surveys, to provide real-time wage data would help.

In the absence of real time official data, the recent ISME survey is helpful. It showed that 50% of the 400 companies it surveyed had introduced a pay freeze and a further 41% had cut pay. The average pay reduction was 13%.

Benchmarking cannot be an upward-only process and should be used, in a transparent way, to reveal the pay differences that have been identified between the private and public sectors and indeed between Irish public sector workers and their international counterparts. The last national employment survey highlighted a pay premium of around 30% for public servants over their private sector counterparts with equivalent educational attainment. Savings must also include the reduction of numbers in the public sector in line with the steep declines in the private sector.

Given the size of the social welfare bill, it cannot be ignored. Initial policy efforts must protect the most vulnerable.

Safeguard capital expenditure as much as possible

In light of the collapse in private sector output, it is important to maintain as high a level of capital spending as possible. It helps to maintain employment and boosts the productive potential of the economy. A detailed and transparent cost-benefit analysis of the capital programme should be produced and then published. Projects that fail the analysis must be replaced by others to keep spending to 5% of GNP.

It might be appropriate to ring-fence some capital expenditure from the rest of the Exchequer Borrowing Requirement and fund such borrowing from the European Investment Bank (EIB).The EIB can, in turn, finance these outlays from its general debt issuance programme, giving rise to a more collegial (if around-the-houses) EU support operation for a vulnerable member's funding needs.

Tax increases are inevitable, but the tax base must be broadened

Ireland has one of the least burdensome net income tax (i.e. income tax plus employee contributions less cash benefits) systems in the OECD, particularly for lower income earners.

Gradually raising both the bottom and top rates of tax is the preferred option. No single sector of society should be seen to be targeted. The government must communicate facts surrounding the tax base and tax burden to the public in a coherent manner.

Tax increases must be signalled so that consumers and businesses can adjust their spending patterns accordingly and avoid the damaging precautionary savings that come with uncertainty around future possible tax increases.

In order to avoid significant income tax increases that impair competitiveness, the government should tackle child benefit. In particular, it is recommended that the child benefit system is operated on a means-tested basis.

Ireland has a large number of people outside the tax net entirely compared with other OECD countries. This needs to be re-examined in the context of broadening the tax base.

We favour the immediate abolition of stamp duty on residential property. A surprise abolition will positively impact the property market and has the potential to be recouped through higher VAT, income tax and capital gains tax receipts.

The government should commit itself to the introduction of a property tax to yield up to €2bn, based on the findings of the Commission for Taxation. A carbon tax would also yield revenues of c.€500m, according to the ESRI.

Fiscal actions need to be transparent

To maintain the credibility of the fiscal targets set out in the Budget, the Minister for Finance, or a senior official in his department, should commit to a bi-monthly press conference to update the public on developments in the public finances.

Ring-fence National Pensions Reserve Fund to repair banking system

We advocate pledging the resources of the National Pensions Reserve Fund (NPRF) to repair the banking system. It has been shown in the case of Sweden that these investments can create a return in two ways: they can contribute to resumption of economic growth and, through a recouping of its initial investment, the net cost can also be substantially less than the gross cost.

The €7bn already committed to the banks should be sourced directly from the existing assets of the NPRF. That would save €3bn in potential borrowing this year (currently the plan is to take €4bn from the fund and to borrow €3bn, or the equivalent of 1% of 2009 and 2010 GNP, to put into the banks rather than as an annual contribution into the NPRF).

The economy

The Irish economy's overreliance on the construction sector, and its demise over the past two years, can be largely blamed for the recent collapse in domestic demand. Growth in the Irish economy in the 1990s in particular was based on a more sustainable model of incentivising business and innovation and attracting investment into the country. Competitiveness slipped during the building boom of this decade, and the overriding aim of economic policy should be on improving this key variable.

Commitment to business-friendly policies

Ireland must once again commit to the 12.5% corporation tax in perpetuity.

Commitment to the European Union

The benefits of EU membership are significant for a small open economy like Ireland. We advocate the ratification of the Lisbon Treaty as soon as possible.

Over-pricing must be highlighted

In sectors such as electricity, waste collection and telecommunications, Ireland has some of the highest costs in Europe. The success of recent entrants into the electricity sector shows the benefits of competition in these industries. Further efforts such as these will ensure lower prices for consumers and businesses, thus increasing competitiveness overall.

Wage costs are being reduced in the market. To ensure flexibility and maximum employment, minimum wage levels will have to be reduced in line with these trends.

VAT changes in labour-intensive areas

A recent European Commission ruling dictates that member states may reduce VAT rates on certain industries, such as restaurants. To maintain employment, Ireland should reduce the VAT rate in these labour-intensive areas. Given the fiscal difficulties, the measure may have to be financed through an increase in excise duty or VAT on less labour-intensive, or price-inelastic, areas.

Education should be a priority

Ireland's universities do not rank as highly internationally as they should. Ireland should continue to entice top academic staff from abroad, ex-pats or otherwise, to further improve its human capital.

Full review of the National Development Plan

Every project within the National Development Plan should be reviewed on a common cost-benefit analysis basis. Those projects that pass this test and that are more labour-intensive could be brought forward.

Choose winning sectors

There are niche areas, such as renewable energy, pharmaceuticals and European service hubs, in which Ireland has had success, which should be targeted as growth areas for the future.

The sovereign debt markets

The international focus on Ireland is understandable, not least given the dramatic deterioration in its public finances and the relative scale of the government's contingent liabilities in the domestic banking system. These calculations, in tandem with some general scaremongering by domestic and foreign commentators, have fuelled the speculative attack by the CDS brigade.

Contingent banking liability grossly overstated

It is often stated in international media and research that the bank liabilities guaranteed by the Irish government amount to 900% of GDP. This is false. While the true number of 250% of GDP is indeed large, it is the former number on which the markets have often wrongly been concentrating.

Irish solvency risks wildly exaggerated

The stock of Irish government debt remains low, amounting to 41% of GDP at the end of 2008 (which includes c.10% of GDP in cash and c.10% of GDP in the NPRF). This could rise to 80% of GDP within three years, but this would simply put Ireland close to the European average at that stage.

Liquidity a more real concern, but so far more apparent than real

The National Treasury Management Agency (NTMA) has adopted a pragmatic approach to current bond market conditions, and the funding strategies have adopted a 'needs must' preference for size over spreads. Forty percent of the funding requirement for 2009 has already been raised at this early stage in the year.

Narrowing current account deficit

Ireland's current account deficit narrowed from 6.4% in 2007 to 5.4% of GNP in 2008. The expected sharp fall-off in consumption and investment, and the subsequent rise in the savings rate, are set to see the current account deficit narrow further in 2009 and possibly turn positive in 2010. The current account position, rather than the government deficit, is the true reflection of Ireland's external dependence for funding.

Take advantage of domestic savings pool

Holdings of Irish government debt by both the domestic banks and the general public are relatively modest. With domestic savings on the rise as Ireland rebalances, a growing resource pool is now available to fund Irish borrowing needs.

Credible, transparent plan will reduce spreads further

A credible fiscal stabilisation plan, in conjunction with improving credit sentiment globally, can transform the Irish funding outlook. Visibility, transparency and access to information in relation to Ireland must be improved through a dedicated ambassador role within the NTMA, in conjunction with the Department of Finance.

The banking sector

The anticipated declines in Irish GDP of at least 10% over the period 2008-2010 and extensive falls in property prices have created large-scale worries about the adequacy of capital levels and liquidity in the domestic banking system. While many of the ills impacting the Irish banking sector are domestically oriented – particularly the over-exposure to property as an asset class – the difficulties for the global financial system have exacerbated the situation for our own banks. So, tough decisions lie ahead and we outline some key measures required to get the banking system back on an even keel.

Get clarity on what is facing the banking system

We need evaluation by independent professional advisors of the property loan books, in order to assess the potential level of losses, along the lines of the current FSA stress tests in the UK. This has recently been completed at Bank of Ireland and is underway at Allied Irish Banks, but an up-to-date exercise should take place at all six covered banks.

Outline minimum acceptable equity targets

We need a target minimum equity tier 1 capital ratio confirmed by the local regulator that will be deemed appropriate by international capital markets.

Extent of losses to dictate approach, but bad bank/asset management company (AMC) most likely option

Decisions taken on the issues above will strongly influence the preferred option on dealing with impaired loans in the larger banks through either an AMC, an insurance scheme or a hybrid arrangement. In all instances, the chosen route must comply with EU guidance, although, the asset management company route appears to be currently gaining momentum.

De-gear balance sheets of smaller institutions, particularly to property

An outline work plan is required to get loan-to-deposit ratios down to 115-120% within a reasonable timeframe for the mid- and smaller-sized banks. As part of this process, commercial property exposures need to be reduced. Private equity funding, if available, should be considered here.

Extension of government guarantee a necessity

The liability guarantee plan should be extended by a minimum of 12 months. It must guarantee new term debt issues on a case-by-case basis and remain in place for as long as necessary on short-term wholesale funding and deposits. The government should possibly consider centralising funding for a period to alleviate the destabilising effect of the weaker institutions coming to the market.

Tougher oversight, but within an international context

There should be improved regulation of financial services. The principles-based approach should be superseded in time by a more detailed regulatory framework, but again this will be led by developments internationally.

Commit to lend, but be cognisant of downturn

We need commitments to lend to the mortgage and SME sectors, although banks need to be cognisant of the substantial economic downturn and not push good money after bad.

The Irish economy and public finances

Fiscal consolidation more successful if focused on expenditure rather than tax

Consolidation of the Irish public finances is now critical for a number of reasons. First, international investors (who hold 90% of Irish government bonds) demand immediate action. It will make further gilt issuance easier, reduce its potential costs and help mitigate the tail risk of a sudden stop in funding. Second, action to correct the gaping deficit may well lead to a confidence boost domestically. The public has, in part, lost faith in the government's ability to contain the slide in the public finances. Third, certainty about the future timing of tax increases is critical in order for businesses and consumers to make sound spending and investment decisions. Fourth, there is a competitiveness angle: reducing our public cost base will mirror the shake-out in the private sector – helping to boost the profitability of export-focused companies.

It is crucial that every sector of society buys into the consolidation effort. The evidence from other successful consolidation episodes is that the public was willing to make shared sacrifices (Finland, Sweden) and that society was not divided. Those societies accepted swingeing cuts in public expenditure and a higher tax burden over a number of years. One of the problems in the Irish case is that the government has yet to fully articulate the scale of the problem. In addition, a public/private sector divide has been caused, in part by the fact that the true pay and pension differential has not been highlighted by official sources.

The evidence strongly suggests that successful fiscal consolidations rely more heavily on current spending cuts (especially pay) rather than tax increases. In a 2007 study, the European Commission states that:*"One of the most important results relates to the composition of adjustment, suggesting that the odds for making a fiscal correction last increase significantly if the adjustment is more expenditure and less revenue-based and if expenditure cuts are mainly on current primary outlays, in particular government wages".*[1]

That rationale is especially compelling in the Irish case. The biggest problem is that current public expenditure spiralled out of control but was affordable as long as tax revenue gushed. Unfortunately, the tax revenue base had huge fault lines and eventually imploded.

That expanding public cost base came at another price. It led in part to Ireland going from a position where its price level was 3.5% below the euro area average in 1996 to one where it has the highest price level in the euro area today – hugely damaging the country's competitiveness. We must not forget either that income tax or firms' social welfare contributions also feed into the competitiveness equation along with corporation tax.

On the positive side, Ireland started the crisis with very low net government debt. At the end of 2008, net debt totalled only €40bn, or 22% of end-year 2008 annualised GDP.

[1] pp. 195, Public Finances in EMU 2007, European Economy No.3 2007 (European Commission publication)

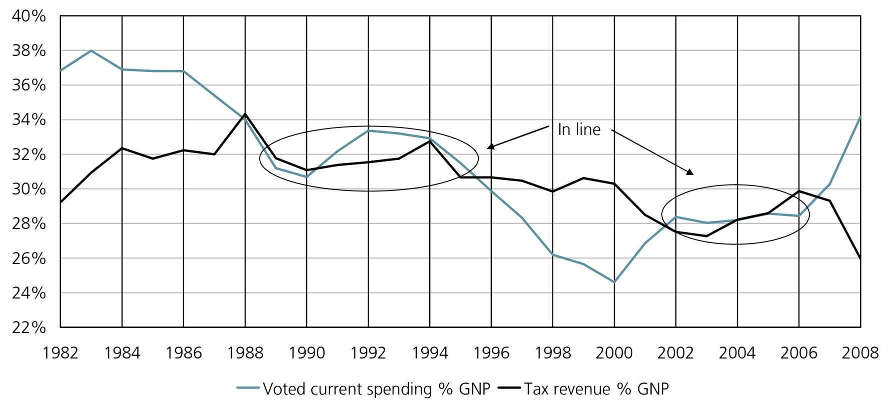
Current expenditure must bear the brunt of the fiscal adjustment

Two separate developments have combined to send the Irish General Government account from surplus in 2007 to a likely deficit of 10% of GDP (after forthcoming budgetary adjustments) in 2009. Tax revenue, which became far too dependent on the bubble in the property market and associated spending, dived. That laid bare the loss of control of public spending from 2000 onwards.

An analysis of the data suggests that, despite the hollowing out of the tax base in the last five or six years, the spiral in current spending is a bigger problem. Gross current voted expenditure, i.e. the part that the government can control directly (excluding interest payments on the national debt which are a given), amounted to 34.2% of GNP last year. That was the highest since 1987 and compares with a ratio of 25-32% over the previous 13 years. But this year, unless further cuts are made, spending will soar to a record level of over 39% of GNP (see Figure 1).

Meanwhile, tax revenue dropped to 26% of GNP last year, the lowest on record back to 1980. That compares with a ratio of 27-31% over the previous 13 years (see Figure 1).

Figure 1: Current expenditure and tax revenue (% GNP)



Source: Department of Finance

So, what adjustments need to be made? There were two periods when current voted spending (i.e. spending controlled by the Exchequer ex-national debt interest payments) more or less equalled tax revenue: 1989-1994 and 2002-2005). Crucially, the economy looks like being about the same size in 2010 as it was in 2005. At that time, voted current spending and tax revenue were bang in line at 28.6% of GNP.

But in 2005, the output gap was close to zero. This time the economy is operating well below capacity, so current spending is higher than at equilibrium due to the increased burden of social transfers while tax revenue naturally undershoots.

We could aim for a tax and current spending ratio equivalent to that witnessed in 2005, which, interestingly, is also more or less in line with the ratios in the 1990-2004 period. But we have to disaggregate the cyclical effects of higher social transfers and lower tax revenue.

On the spending side, it is a case of targeting the same level of voted spending as a percentage of income excluding social welfare payments that pertained in 2005. At that point, the non-social welfare components of voted spending, i.e. pay and the day-to-day cost of running public services, amounted to 19.6% of GNP. To return to that level implies cuts of €7.3bn in the non-social welfare bill.

As for tax, there is a cyclical and structural component. The structural loss of tax from the housing bubble compared with 2005 amounts to over €5bn. The cyclical tax loss (focusing on income, corporation tax, non-housing VAT and excise duty) based on our tax estimates for 2010 is between €3bn and €3.5bn.

The burden of social transfers will recede and cyclical tax revenue will rise as the output gap closes. We still suggest that social welfare rates need to be examined in the context of deflation in consumer prices, but higher unemployment causes most of the rise in payments. If we assume that the economy reaches potential again by 2014, the plan should consist of cutting the structural deficit over that timeframe. That demands about €7.5bn in current spending cuts and €5bn in tax increases, ideally kept away from labour in large part.

We must also be cognisant of weighing the deflationary impacts of doing too much too soon. This is where a multi-annual Budget framework is required, which strictly sets out the changes that will be made on taxes and spending in the period up to 2013. But to start: in next week's Budget we suggest finding €2.5bn in additional current spending and €1.5bn in increased revenue in 2009 – hopefully enough to keep the deficit to 11% of GDP.

Public sector pay bill must form part of the adjustment

The public pay bill has almost tripled since 2000 to reach almost €19bn (encompassing the recent pensions levy) in 2009. This increased cost base has led to a cost-push impact on prices across the economy and has not been matched by improvements in productivity. At a minimum, savings of c.€4bn need to be made to bring public pay/GNP back to 11%, in line with the 2003-2007 average.

Pay cuts must form part of the overhaul. The attraction of pay cuts is that they match what is already taking place across the private sector (the demonstration effect is already clear) and they avoid distortions across the economy. They are also the quickest way to get costs down.

It is important to dispel the notion that there is a witch-hunt against public sector workers. What would help is if the facts about wages were spelt out to the public. Public sector weekly wages were higher than private sector wages for each individual occupation level and for the same level of educational qualification in 2006 (see Table 1; the 2007 survey is due in May). The gap for the overall average is much wider than at that micro level, but this is understandable given that the spread of jobs is skewed away from manual work towards managerial roles in the public sector.

Considering the deep pay cuts now happening right across the private sector, there is scope for a new benchmarking exercise. If wages were benchmarked upwards to supposedly match similar roles in the private sector during times of plenty, the corollary suggests that the same exercise could lead to equivalent pay reductions during this deep recession. An 'upward only' review process is not defensible.

Fast-tracking the collection of statistics would help cement the impression that cutbacks are fair. Many private sector firms have announced wage cuts, but they will not show up in the data for at least six months because of lags in collection and compilation. Increased resources could be committed to the Central Statistics Office to prioritise the reporting of wage data.

Table 1: Private sector versus public sector mean hourly earnings by occupation and educational attainment (€)

	Private	*Public*	*% premium*		*Private*	*Public*	*% premium*
By occupation				**By education**			
Managers and administrators	30.6	37.5	22.5	Primary or lower secondary	14.3	18.9	32.3
Professional	27.2	36.9	35.8	Higher secondary	15.4	20.6	34.0
Associate professional and technical	19.5	23.6	20.7	Post Leaving Certificate	17.7	20.7	17.0
Clerical and secretarial	15.5	18.6	20.0	Third-level non-degree	18.3	23.3	27.1
Craft and related	16.6	18.9	14.0	Third-level degree or above	26.5	34.5	30.0
Personal and protective services	12.0	21.3	77.7				
Sales	13.0	N/A	N/A				
Plant and machine operatives	14.7	19.1	30.2				
Other	12.3	15.9	29.2				
Total	**17.5**	**26.1**	**49.2**	**Total**	**17.5**	**26.1**	**49.2**

Source: CSO

Job reductions required: obvious cuts in bloated administration and middle management need not affect service delivery

Pay reductions are not the full solution by any means. Even though job cuts will not deliver immediate savings due to redundancy payments, they must be firmly on the agenda. Numbers employed directly in the public service have surged from 301,500 to 369,100 in the period Q4 2000-Q3 2008, and it is apparent that front-line staff numbers have not increased markedly: the swelling of numbers has been driven by the creation of administrative posts and by the proliferation of agencies.

Some micro analysis identifies what areas have scope for significant reductions. Education jumps out. We think that the country needs to continue to invest hugely in human capital in order to boost future living standards. But the rise in numbers employed in education in recent years has been skewed towards non-teaching personnel. The latest data for September 2008 show 97,900 people employed directly by the Department of Education and Science, some 4,400 more than a year previously. At that point, in September 2007, there were 47,992 teachers employed (the latest teacher data available) and 45,508 others. These 'others' had increased by almost 20,000 (or 76%) since 2000 whereas teacher numbers rose by less than 7,000 (or 17%). While recognising the need for staff in areas such as special needs, efficiency savings in administrative positions should be identified.

Equally, there is scope for cuts in the health administration budget. In the period 2000-2008 (end-year), direct HSE employees (full-time equivalents) increased by 31,000 to 106,300 – a gain of 39%. Within that, support staff and management/administrators increased by 11,250, or 30%, to 48,800. We cannot fathom how almost 49,000 management/administrative staff are needed to cater for 62,200 front-line medical and social care workers. Again, there must be scope for at least 10,000 in cuts from support staff.

Pensions

The pensions bill accounts for 10% of the public pay bill but has increased 63% in five years. It is not a huge drag now, but that reflects the relative youth of the Irish public sector. A new template for public pension provision is worth examining as this is key from the viewpoint of longer-term fiscal sustainability. Given its young population, Ireland has a window of time to address this. This crisis provides the opportunity to deal with the issue head-on.

Social welfare spending too big to ignore

Inflation-adjusted social welfare rates are set to rise sharply this year due to lower prices across the economy. The Consumer Price Index, a proxy for the cost of living, will drop by 4% in 2009 and may fall another 2% in 2010. Yet social welfare rates increased by about 3% in the Budget of last October. That translates into a real jump in welfare payments of 7% this year. It may be difficult politically to push through a reduction in social welfare rates in 2009. In addition, there is some merit in not cutting social transfers too much as automatic stabilisers should operate in a downturn and some of the outlay will be recouped in taxes on spending.

But the bottom line is that the increase in unemployment is putting additional stress on the public finances, existing workers and businesses. We think that the social welfare bill will be some €500m higher than the government's latest estimate due to the spike in unemployment claimants this year. This issue has to be tackled for 2010. Each 1% increase in social welfare rates would cost about €225m from the higher base of claimants. In other words, a 2% cut in the rate next year may save close to €500m. Working on the principle of protecting the most vulnerable, initial efforts on this front should concentrate on means-testing some of these payments.

Efficiencies can generate huge savings if procurement, IT and payroll are centralised

It is impossible to identify exact efficiency savings in the public service without being able to see its workings at first hand. We expect the Special Group on Public Service Numbers and Expenditure Programmes, led by Colm McCarthy, to make recommendations having trawled through the different departments and agencies. Implementing change is likely to be glacial, so it will not have an immediate impact on the bottom line of the public finances, but an efficiency drive will increase productivity, lower costs and improve living standards for the population over time.

There are a number of simple suggestions that could generate savings:

- There is no centralised human resource function for the public service. Remarkably, if a doctor moves hospital, he or she must de-list from the previous one and sign on at the new one. Payroll for all staff, if not for the entire public service, should be centralised in the HSE.
- IT systems often do not talk to each other; rather, a proliferation of different systems is used. One MIS system should be in place for the Revenue Commissioners, HSE, Department of Education and Science and other government departments.
- Centralised procurement for the whole public service would save hundreds of millions by generating massive economies of scale.

Capital spending is absolutely critical: only source of resilient demand in the economy and lifts future living standards

It is critical to maintain as high a level of capital spending as possible. Other countries are focussing their fiscal plans on infrastructure because this serves two benefits: (i) it is the easiest way to put people to work and (ii) it boosts the country's capital stock and hence productive potential. During this recession, the government is the only resilient source of demand in the economy. There is so much slack in the construction industry at present that volumes can be delivered at much lower costs than before.

It is worth keeping in mind that international investors are quite prepared to finance capital spending. They are well aware that the higher the level of productive infrastructure, the more it increases potential national income and sustained tax revenue in the future.

Note that this year's General Government Deficit would be over four percentage points of GDP lower if capital spending was zero. Ireland should look to enter discussions with the EIB to finance certain projects.

In 1986-1989 and 2003-2004, when the economy ran into trouble, capital spending was the first to go. That is a false economy, and the brave decision is to concentrate on current rather than capital spending.

But a detailed and transparent cost-benefit analysis of the capital programme (apart from the completion of the motorway projects by end-2010) should be produced and then published. If some projects no longer meet the required threshold, they should be replaced by fresh initiatives – ideally ones with a high labour input.

Tax revenue needs to be re-balanced to sustainable sources

We have highlighted how tax revenue became so dependent on transaction-related taxes, related to either property or consumer purchases, in recent years. Tax revenue from stamp duty, capital gains tax, VAT and excise amounted to 50% of the total in 2000. That rose to 57% by 2006 and will drop back to about 49% this year – a decline of €9.5bn in just three years.

Tax revenue needs to be re-balanced so it ideally becomes less sensitive to asset booms and busts. Income tax needs to garner a greater share of the total over time, but that part of the tax base obviously remains cyclically sensitive. Ideally, we should avoid drastically increasing the tax burden on labour in the midst of a deep recession as it will stymie business investment and may lead to a drain of human capital through increased emigration.

Unfortunately, the current reality is that income tax increases are a necessary part of the fiscal retrenchment. The easiest political option is for the government to raise the top rate of tax while leaving the tax base and lower rate untouched. However, given the scale of the required adjustment, it is necessary for the government to consider a wide range of tax options.

Widening the tax base by dropping the personal tax credits by €100 would yield approximately an extra €220m in a full year. A 1% increase in the lower standard rate would yield approximately €565m, while increasing the top tax rate by 1% would bring in an extra €281m. A €3,000 reduction in the threshold at which people begin paying the higher marginal rate would yield approximately €370m. Finally, the abolition of the PSRI ceiling would bring in an additional €300m. It is clear from these figures that changes in the tax system must be broad-based; focusing on just one segment would not bring sufficient revenue for the government to help in closing the deficit.

There are good arguments to be made for including as many people in the tax net as possible because of their use of public services. It is worth noting that in the last ten years the number of taxable incomes exempt from paying income tax (i.e. standard rate liability fully covered by credits or age exemption limits) has increased from 25% of income earners to 36% as successive tax credit/allowance increases took people out of the tax net. There is clearly scope to bring more people into the tax net, but any plan to do so must take into consideration the disincentives that such a policy would have on labour market participation.

Ireland has one of the least burdensome net income tax (income tax plus employee contributions less cash benefits) systems in the OECD, particularly for lower income earners.

The evidence shows that Ireland's tax burden for single (childless) income earners at or below the average wage is well below the OECD average. For couples with children, the net tax burden in Ireland is significantly below the OECD average for all income levels. This stems from the generous child benefit system which gives equally to all parents regardless of income. For 2009, child benefit is budgeted to cost the state €2.5bn. With this evidence in mind, the following is suggested:

- In order to avoid over-burdensome income tax increases, the government should tackle child benefit. In particular, it is recommended that the child benefit system be operated on a means-tested basis.
- Gradually raising both the bottom and top rates of tax is the preferred option. No single sector of society should be seen to be targeted – the

government must communicate facts surrounding the tax base and tax burden to the public in a coherent manner.

Table 2: Income tax plus employee contributions less cash benefits, by family-type and wage level (as % of gross wage earnings), 2007

Family type:	*single*	*single*	*single*	*single*	*married*	*married*	*married*	*married*
Children	*0*	*0*	*0*	*2*	*2*	*2*	*2*	*0*
Wage level (% of avg. wage)	**67**	**100**	**167**	**67**	**100&0**	**100&33**	**100&67**	**100&33**
Australia	19.1	23.4	28.8	-10.7	10.0	14.9	18.9	19.6
Austria	27.8	33.5	37.9	7.1	19.8	20.5	24.0	29.5
Belgium	35.3	42.0	48.8	17.5	22.4	26.6	33.0	34.7
Canada	18.1	23.3	26.9	-14.3	10.6	15.5	19.0	19.9
Czech Republic	19.7	22.9	28.0	-13.0	-6.3	4.7	10.9	20.7
Denmark	38.8	41.0	49.5	13.3	29.3	34.0	35.7	38.9
Finland	23.4	30.1	37.4	8.8	22.9	20.7	23.1	26.2
France	25.8	27.8	33.2	14.5	17.5	17.7	22.0	23.8
Germany	37.0	42.8	45.9	21.7	23.9	30.0	34.5	37
Greece	18.9	26.1	32.8	17.7	26.5	23.9	24.9	24.5
Hungary	26.9	38.7	44.4	3.6	24.4	22.5	25.4	33.2
Iceland	19.5	24.4	28.4	1.2	6.7	15.1	20.1	19.5
Ireland[1]	**9.8**	**18.3**	**28.7**	**-38.6**	**-5.2**	**2.2**	**7.4**	**5.2**
Italy	23.4	28.5	34.8	-3.0	12.5	16.8	21.0	23.8
Luxembourg	22.0	29.1	36.8	-4.5	2.8	7.8	13.7	20.2
Mexico	-1.2	5.2	13.8	-1.2	5.2	0.9	2.7	0.9
Netherlands	30.7	35.4	40.3	6.9	26.9	26.6	29.2	32.0
New Zealand	19.1	21.5	27.3	-15.6	2.8	11.4	17.3	20.4
Norway	25.7	29.5	35.9	9.6	21.5	22.6	24.7	26.7
Poland	29.7	31.1	32.3	24.7	24.7	24.7	26.1	29.7
Portugal	16.6	22.5	29.6	5.7	10.3	11.9	16.8	16.6
Slovak Republic	18.7	22.4	25.2	2.8	4.4	10.7	14.6	18.7
Spain	16.1	20.4	25.3	6.4	12.4	15.3	16.2	16.9
Sweden	24.9	27.6	37.9	13.2	19.8	19.4	21.8	25.3
Switzerland	18.7	21.8	26.6	3.2	9.3	12.0	15.3	19.4
Turkey	29.2	30.3	32.4	29.2	30.3	29.8	29.9	29.8
United Kingdom	24.0	27.0	30.7	7.2	20.6	19.2	22.6	24.0
United States	22.1	24.5	30.3	0.3	11.8	16.0	18.6	22.2
Unweighted average:								
OECD	22.1	26.6	32.2	4.0	14.5	17.1	20.4	23.0
EU-15	24.7	29.9	36.5	5.5	17.0	19.2	22.8	25.3
EU-19	24.5	29.6	35.6	5.3	15.9	18.5	22.1	25.4

1. The figure for Ireland has been adjusted to take into consideration the average wage in contrast to the OECD figures for Ireland which look at the average production wage. This is done for comparison purposes as all the other countries in the list above are measured relative to the average wage. Since the average wage is greater than the average production wage, this adjustment increases the contribution that households make in tax payments as a percentage of gross wages.
Source: OECD and authors' calculations

- Tax increases must be signalled so that consumers and businesses can adjust their spending patterns accordingly and avoid the damaging precautionary savings that are caused by uncertainty around future possible tax increases.
- Ireland has a large number of people who are outside the tax net entirely. This situation must be re-examined but must not be done in isolation from social welfare payments.

In relation to capital taxes, there is no point whatsoever in raising them at a time when the majority of taxpayers are carrying forward losses. Equally, because asset markets are so weak, those holding assets that still show a paper gain are unlikely to sell in the short term. Raising taxes on capital would cause further unnecessary damage to Ireland's formerly great reputation as a place to do business.

Revenue can be raised without unduly penalising the incentive to work in 2009 by the following measures:

- The introduction of a property tax, skewed more towards second and additional homes (including those owned abroad), could raise €2bn in a full year. Ideally, this should be introduced in time for the supplementary Budget to keep the tax rises away from labour as much as possible. But it looks like we will have to await the report of the Commission on Taxation for its introduction.
- Stamp duty should be scrapped as it is an unnecessary impediment to liquidity in the residential property market. Stamp duty foregone will come to about €200m this year. That has the potential to be recouped through higher VAT, income tax and capital gains tax receipts.
- A carbon tax could raise €500m in a full year.

Ring-fence NPRF to repair the banking system

It would be helpful if the government made a statement that all of the funds in the NPRF are being earmarked to deal with the banking problem. Ideally, this statement should be made alongside a coherent plan for the future of Irish banking.

The bond market wants to see two things: that the government has stemmed the rise in the deficit and that everything is being done to limit the deficit's absolute size (i.e. the lower the final level, the better). To help achieve the second goal, the €7bn committed to the banks should be sourced directly from the existing assets of the NPRF. That would save €3bn in potential borrowing this year (currently the plan is to take €4bn from the fund and to transfer the annual contribution of 1% of GNP for 2009 and 2010 into the banks rather than into the NPRF).

Competitiveness lost: we must return to late-1990s exporting model

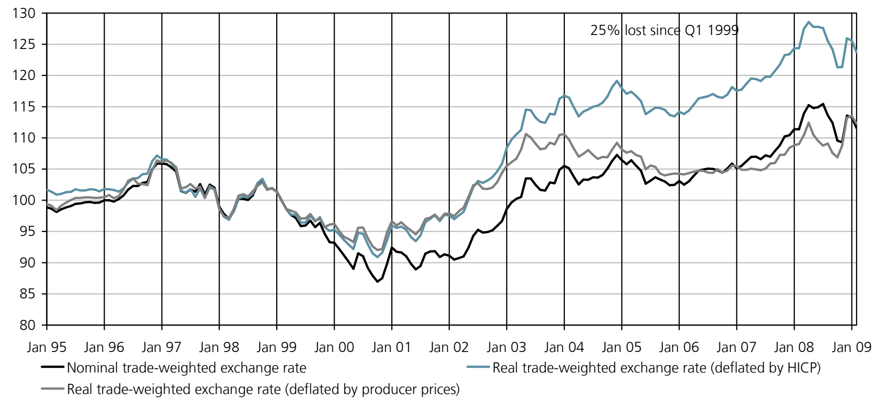
Global shocks, combined with the end of the property bubble, have set in motion a self-reinforcing cycle of declining asset prices, investment, employment and consumption. The government's ability to counter this cycle has been hampered by the need to repair the public finances. With the domestic part of the economy adjusting, Ireland must return to the successful export-led model of the late 1990s in order to revive growth and employment.

But this requires policy action as Ireland has become uncompetitive

Robust domestic growth over the 2003-2007 period diverted attention from the significant loss of competitiveness in the Irish economy. With the veil of unsustainable construction-led growth now lifted, the Irish economy stares starkly at the reality that it is uncompetitive relative to its trading partners.

Between January 2000 and December 2008, Ireland experienced a 32% loss in international price competitiveness (real HCI), reflecting a combination of higher price inflation in Ireland (approximately one-third of the loss) and an appreciation of the euro against the currencies of many of our trading partners (nominal HCI).

Figure 2: Harmonised competitiveness indicators for Ireland (HCIs)



Source: Central Bank of Ireland

Improvements in competitiveness lessen imbalances in the economy

Going hand in hand with the domestic construction boom and the loss of competitiveness was the deterioration in the current account. The current account went from roughly balance in 2003 to a deficit of 6.4% of GNP in 2007. The current account deficit actually narrowed from the 2007 level to 5.4% of GNP in 2008.

An improvement in Ireland's competitiveness has the potential to boost exports and thus cause the current account deficit to narrow even more quickly. Ireland's current account balance is likely to narrow further in 2009 and could even turn positive in 2010. The current account position, rather than the government deficit, is the true reflection of Ireland's external dependence for funding. A scenario where the current account is in surplus implies that there are sufficient funds in the Irish economy to fund the government deficit providing funds can be channelled into government bonds (see section on Irish debt financing for more details). This does not abrogate the government's need to initiate comprehensive reform but serves to highlight that fiscal credibility, improvements in competitiveness and a reduction in liquidity risks are all interlinked.

Given that Ireland has no control over exchange rate policy, competitiveness must be regained by reducing the level of costs relative to our trading partners, increasing productivity and promoting pro-business/competitive initiatives. In particular, Ireland must meet a number of challenges so that the economy can capitalise on the global upturn when it arrives:

- Promote labour market flexibility in the public sector as much as in the private sector.
- Safeguard our corporation tax advantage.
- Put in place a credible fiscal framework so that the rapid deterioration in the public finances is never repeated. In the Netherlands, multi-year budgetary targets are based on a coalition agreement that is triggered when a new government enters office. The forecasts underlying the targets are based on independent assessments of the economic environment. The ESRI might provide this in Ireland.
- Continue to invest in our capital stock to bring it in line with developed country standards.
- Invest in human capital to preserve our healthy labour supply advantage.
- Restore the reputation of Ireland as a good place to do business.
- Identify niche sectors where Ireland can become best-of-breed and draw on its competitive advantages (e.g. European shared service hub, renewable energy, pharmaceuticals).

Reducing costs relative to our trade partners

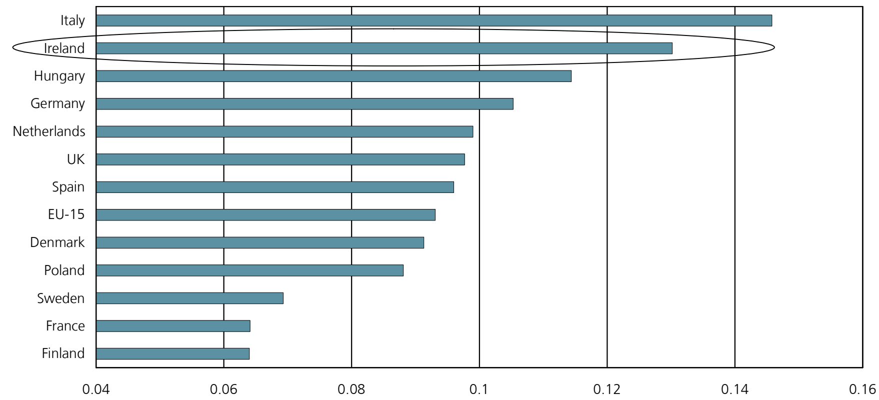
The quickest and most effective method of decreasing costs is through a reduction in the wage bill. Job losses and wage cuts are spreading across most of the economy. The shakeout in the private sector will cost many in terms of living standards but will pave the way for significant gains in competitiveness.

The downward flexibility of wages in the private sector is a positive development and signifies Ireland's ability to adapt as circumstances change. Yet, as discussed earlier, the same adjustment process is not being repeated in the public sector. Rising public sector pay costs have already had a cost-push effect through to the price of final public services in recent years – most obviously in health, education, public transport and utility prices.

The competitiveness of the Irish economy is a function of both the private and public sector. The best way to ensure that the competitive adjustment is occurring across the economy is to undertake another benchmarking exercise, comparing wages in the public sector with the private sector.

Non-wage costs, particularly utilities, are a significant cost for both hi-tech multinational firms and SMEs. On this front, Ireland also has significant room for improvement. For example, Irish industrial electricity costs are the second-highest in the EU-25. Irish prices increased by 70% between January 2000 and January 2007, which was more than twice the average rate of increase across the EU-15 (32.8%). Ireland's dependence on imported fuels means that electricity prices are particularly exposed to global price movements. A micro-report in 2005 by consultants Deloitte estimated that domestic controllable costs accounted for 30% of the difference between Irish and average EU electricity prices.

Figure 3: Industrial electricity prices (excluding VAT but including all other taxes), 2008 (€/KWh)



2007 data used for Italy due to data availability.
Ireland ranks 14th out of EU-15.
Source: Eurostat

Non-wage costs more generally in Ireland compare poorly with other countries across a range of cost types. This was highlighted in the National Competitiveness Council's benchmarking exercise, which showed that Ireland performed poorly in property costs (both purchase and rental), utilities costs and a range of domestic services such as accountancy, information technology and legal services fees.

Enhancing competition within Ireland's domestic economy is vital to improving our overall competitiveness. If sheltered sectors of the locally traded services sector are not exposed to greater competition, services inflation will continue to outpace the euro zone average and the cost competitiveness of Irish firms will deteriorate further. The Competition Act does not require the government to acknowledge or respond to advice from the Competition Authority. This leads to a lack of government focus on competition issues and leaves the door open for vested interests to sweep reform recommendations under the carpet.

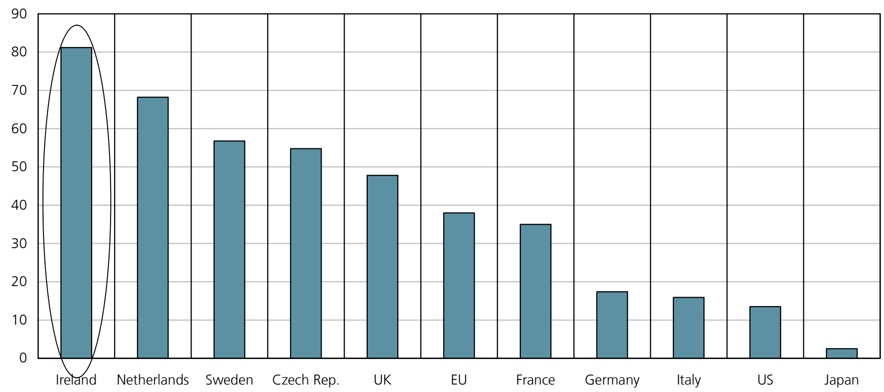
Legislation should be amended to require a formal government response to recommendations made to it from the Competition Authority under Section 30 of the Competition Act, 2002. There should be a statutory time limit attached to this subsection.

Business environment was so attractive, but reputation needs to be restored

The main reason that Ireland attracted so much foreign direct investment (FDI) over the last 20 years was that its whole business environment was so attractive.

In a recently published survey of EU and US innovation and competitiveness, Ireland ranked 13th out of 36 countries. Ireland ranked poorly in terms of corporate R&D (23rd), government R&D (31st) and researchers (19th). These are disappointing figures and highlight Ireland's inability to date to build on the significant FDI that the country has enjoyed over the last two decades. On the other hand, Ireland ranked highly in higher education (6th), corporate tax (5th) and business climate (4th). It is because of these latter variables (and also the proximity to Europe, the use of English as a first language and the low tax wedge) that Ireland has been able to attract significant FDI into the country. This is reflected in the survey – Ireland is ranked 2nd for attracting FDI.

Figure 4: Stock of Foreign Direct Investment (% of GDP)



Source: OECD

These positive factors are still in place in Ireland. If confidence in Ireland can be restored, the country will continue to attract significant FDI. A number of actions can help to restore our reputation as an attractive place in which to do business:

- Promote labour market flexibility in the public sector as much as in the private sector.
- Commit to 12.5% corporation tax rate into perpetuity. We need to make it clear that every EU country has a veto on this issue.
- Note that Ireland has relatively light regulation in a global context and this has attracted FDI. So it is vital to work with the authorities on any new regulatory framework. Financial services may be structurally impinged, but treasury and fund administration has become an important industry – we need to ensure that our relative position is safeguarded by addressing any concerns that the European Commission may harbour.
- Our reputational capital has suffered numerous blows in the last six months. There are a number of measures that could help restore a

previously good reputation: a credible fiscal strategy for the next number of years is the most important plank (investors want hard decisions taken); a clear plan for the future of the banking system with a plan to address the bad debt problem; and a new slate in terms of domestic regulatory structure/personnel.

- The tax wedge on labour is one of the lowest in the OECD but is skewed towards lower earners. It is not compellingly attractive for foreign highly-skilled workers, damaging the economy's productive potential.
- The social security burden on companies is below average in an OECD context. US companies in particular are impressed by that model, and it is worth trying to keep it that way.
- It is vital to work with the EC and not be adversarial. A ringing endorsement of the Lisbon Treaty would help. The protectionist drive globally is a major threat for a small trading economy: we must do everything to help prevent that phenomenon by assisting the EC politically.

Capital programme is vitally important for economy's future

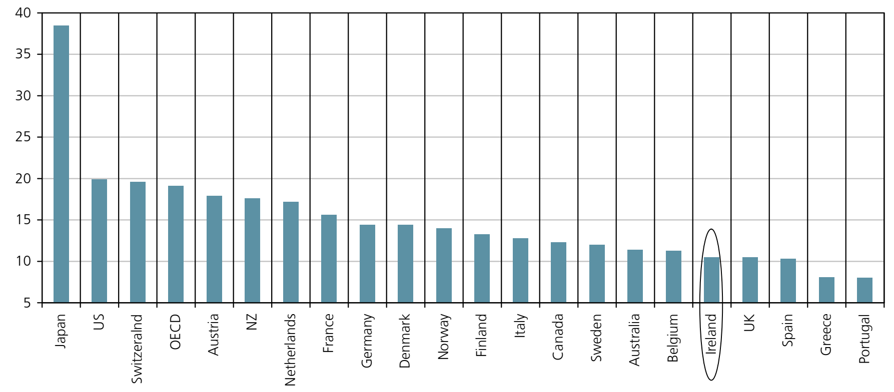
Maintaining a high level of infrastructure is vitally important for the economy's future productivity. Ireland is still near the bottom of league tables for the level of capital stock. We must continue to spend more on infrastructure and technology than our trading partners for many years to come. The budget is for 5% of GNP per annum until 2013. Keeping spending at this ratio of GNP must be the target even if changing the mix (towards more labour-intensive projects) is necessary.

A detailed and transparent cost-benefit analysis of the capital programme should be produced and then published. Projects that fail the analysis must be replaced by others to keep spending to 5% of GNP.

The country has transformed its transport infrastructure over the last decade. The inter-urban motorways/high-class dual carriageways are slated for completion by end-2010. That is a salient target.

Although Ireland's GNP per capita (a measure of annual national income) is high in an OECD context, wealth lags behind as measured narrowly by our productive capital stock (see Figure 5). Ireland’s level of public capital stock was just over half the OECD average in 2004 (though it would be somewhat more flattering if we had up-to-date data).

Figure 5: Public capital stock per person (€000s), 2004



Source: OECD

Investors are quite happy to finance the part of the deficit that arises from capital spending. They recognise that investing in an economy's productive capital stock will lift the trend line of tax revenue into the future. Nonetheless, the government could explore the possibility of using the EIB to finance some projects.

We need to prevent the rapid deterioration in the fiscal balance from occurring again. We suggest setting up an Irish "golden rule", where borrowing is only permitted for capital spending purposes. The best way to ensure that the framework stays intact is to siphon off any cyclically-adjusted surpluses into a 'rainy-day' fund to use in more difficult times. To remove the possibility of political influence over budgetary policy, these targets should be set in law and strict enforcement passed over to an independent body elected democratically.

Human capital our greatest advantage – we must keep the current generation of graduates here and invest in the next one

Ireland has the highest number of graduates in the 25-34 age group of any country in the EU with the exception of Cyprus. We need to keep these graduates here – a challenge made difficult by the deep recession. Low tax is crucial to incentivise work: it is another reason to minimise the tax adjustment (as well as the historical evidence that successful fiscal consolidations rely more heavily on expenditure rather than tax). Moreover, successful fiscal measures may help shore up the labour market if they improve confidence. That will help to keep more of our talent at home.

Front-line education must be a priority. The numbers show that growth in education numbers has been skewed towards non-teaching staff. The programme announced by the government to boost the number of PhD graduates is helpful. However, many courses do not focus enough on practical skills for the workplace, and that should be addressed. In addition, Ireland's universities do not rank as high as they should in European league tables. We suggest aiming to push our top four universities into the European top-50 by, for example, 2019. This may require attracting top academic staff from abroad (ex-pat or otherwise).

Renewable energy, tourism and European service hubs are worth targeting

Governments have a far from perfect record in choosing winning sectors; markets usually do a better job. But Ireland has had some success in the past – the IFSC is a good example. There are niche areas where Ireland may have a comparative advantage and which may merit special emphasis.

An obvious candidate for special focus is renewable energy. Ireland's climate is ideal to harness wind and wave power. Reducing our dependence on imported fossil fuels could significantly improve living standards and diminish the effects of the economic cycle.

Ireland's tax advantage and high level of science graduates make it a good location for investment by pharmaceutical companies. This has had a spillover effect in spawning our own successful indigenous pharma sector. In this context, we must make sure to attract those multinational pharma companies with the next round of top patents.

European hubs are a major success story. For example, Google now employs approximately 1,500 from a standing start six years ago. Facebook recently announced that it was setting up its European shared service centre in Ireland. Many other multinationals have established centres in Ireland to service treasury, marketing, administration and R&D for their European subsidiaries. The low corporate tax rate, skilled labour supply, favourable business climate and language are crucial factors in this regard.

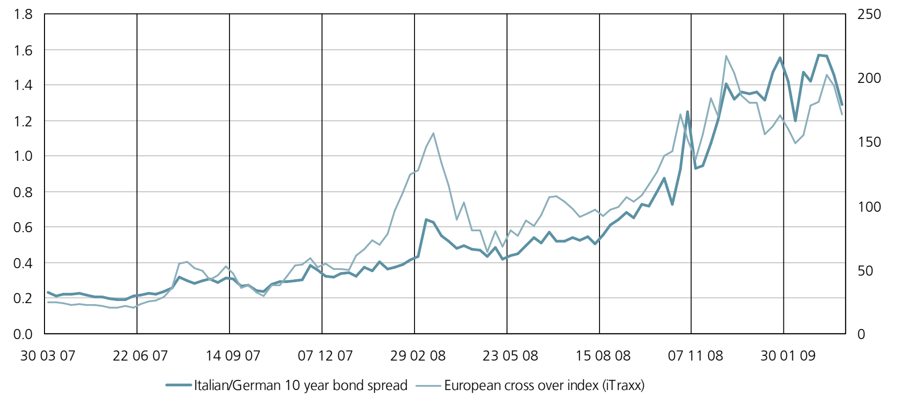
Tourism is an indigenous sector employing 280,000 people. It has never been taken seriously enough at policy level. Yet it has the potential to significantly increase earnings, and its high labour input means that the multiplier effect is substantial. It will benefit hugely by any diminution of Ireland's cost base over the next couple of years. Given that access is the most important factor in attracting visitors, the ill-advised travel tax should be discarded immediately.

The sovereign debt markets

EMU fault lines

The sharp widening in Irish sovereign debt spreads (cash and CDS) over the past six months cannot be viewed in isolation. Rather, it has been part of a systemic widening of EMU country spreads versus their German benchmarks to levels unseen since the euro's inception in 1999. This process has been underway since the start of the global credit crisis in August 2007, during which time a general re-pricing of financial asset risk has seen both 'core' and 'peripheral' spreads track the broader credit indices wider (Figure 6). In addition, the enforced de-risking of investment banks and hedge funds has exacerbated the liquidity constraints on the smaller sovereign bond markets (Ireland included), with heightened illiquidity premia reinforcing the spread widening trend.

Figure 6: European crossover index (iTraxx) and Italian/German bond spread (10 yrs)

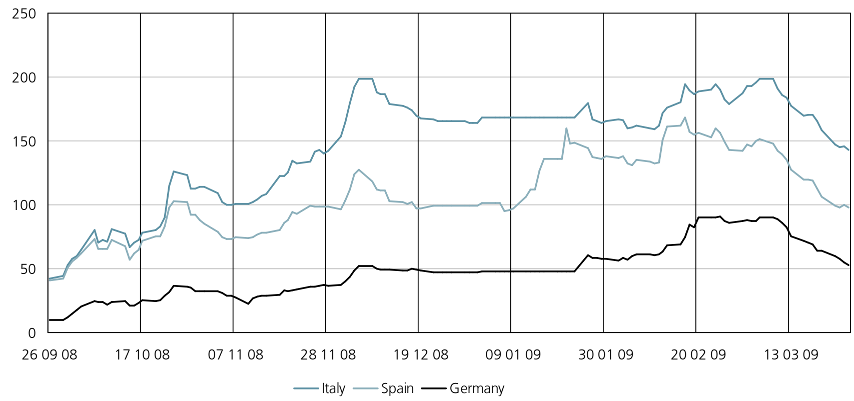


Source: Bloomberg

Exposed by deteriorating public finances and mounting default risk

Spread widening has intensified in the aftermath of the Lehman bankruptcy. The rapid deterioration in global economic performance, together with the increased 'socialisation' of banking system risks, has placed the bond market spotlight firmly on deteriorating public finances. Previously moribund sovereign CDS spreads have catapulted wider, reflecting speculation regarding the relative probability of debt default by individual governments or even (in the case of Euroland names) the possibility of an EMU break-up (Figure 7).

Figure 7: Euroland CDS spreads (5 years)

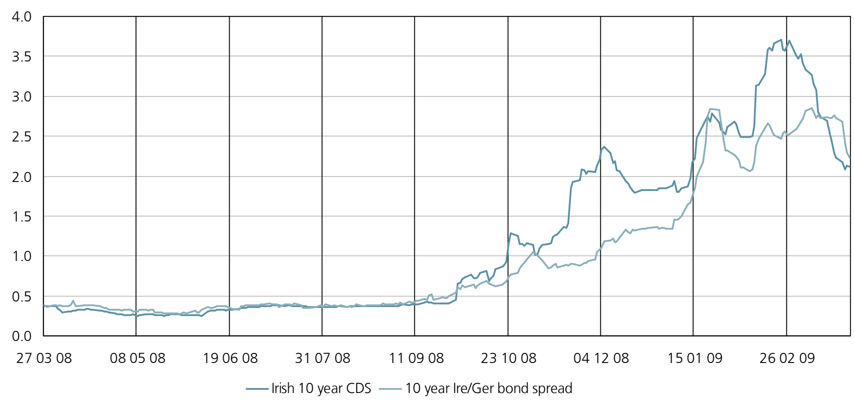


Source: Bloomberg

Ireland singled out for unfavourable treatment

Having kick-started the global transference of risk from private to public hands with its guarantee of bank liabilities on September 29th 2008, Ireland has been singled out for particularly unfavourable attention regarding sovereign default risk. At peak CDS readings near 400bps in mid-February, the cumulative default probability being assigned to Irish sovereign debt over the next five years exceeded 30%. Negative feedback loops from such CDS pricing have been all too apparent in the underlying cash market, where ten-year spreads to Germany spiked to wides of 300bps (Figure 8).

Figure 8: Irish 10-year CDS and 10-year Ireland/German bond spread



Source: Bloomberg

Situation not helped by market misinformation and general scaremongering

The international focus on Ireland is understandable, not least because of the dramatic deterioration in its public finances but also because of the relative scale of the government's contingent liabilities in the domestic banking system, particularly in a Euroland context. These calculations, in tandem with some general scaremongering by both domestic and foreign commentators, have fuelled the speculative attack by the CDS brigade.

Irish solvency risks are wildly exaggerated, albeit liquidity concerns less so

Concerns regarding Irish solvency risk appear sorely misplaced. The stock of Irish government debt is low, both in absolute terms (net debt 19% of GDP end-2008) and relative to its Euroland peer group (68% of GDP). In combination with historically low interest rates, Ireland's debt-interest burden amounted to 3.8% of total tax revenue and 1% of GDP in 2008 compared with peak readings of 33.3% and 10.5% respectively in 1987. Although Ireland's debt/GDP ratio will rise sharply in coming years (close to 80% by end-2011), even this – in tandem with projected increases in funding costs – will still leave the debt-servicing burden in line with the European average and similar to the Irish experience of the mid-1990s (Table 3).

Table 3: Euroland sovereign credit metrics

	Credit rating	*Debt/GDP (%)*			*Interest costs (% GDP)*				*Bank guarantees*	*10 year CDS*	*10 year spread vs Germany*
	S&P	*2008*	*2009*	*2010*	*2008*	*2010*			*% GDP*	*bps**	*bps**
						Stress 1[a]	*Stress 2[b]*	*Stress 3[c]*			
Germany	AAA	64	69	71	2.1	2.2	2.5	2.8	17	58	-
Greece	A-	92	96	99	4.5	4.9	5.1	5.3	7	184	247
Ireland	AAA**	41[d]	59	73	0.8	2.3	2.6	2.9	237	244	249
Italy	A+	103	108	112	4.8	5.2	5.4	5.6	0	148	139
Spain	AA+	36	42	45	1.6	2.2	2.4	2.5	19	112	103

a. Unchanged debt servicing costs
b. Existing debt servicing costs +50bps
c. Existing debt servicing costs +100bps
d. Net debt/GDP ratio of 22% after allowance for cash-at-hand and NPRF balances
* March 31st 2009
** Ireland is still rated AAA by Fitch and Moodys, but AA+ by S&P
Source: Davy

Favourable demographic trends also enhance Ireland's ability to self-finance its national indebtedness relative to our Euroland counterparts. Its dependency ratio is the lowest in Euroland.

Elevated Irish sovereign spreads clearly exaggerate fundamental credit risk, but in themselves they have raised the spectre of liquidity risk in the context of a potential 'buyers strike' for Irish government paper. This is an unpalatable scenario at the best of times, but particularly so given the current pronounced funding needs. Ireland's added vulnerability is the bond market's substantial dependence on foreign investors (circa 90% of total outstandings) which, in the midst of a prevailing 'home bias' for global capital flows, raises the threat of a funding disruption to the debt issuance programme of the NTMA.

Such concerns are more apparent than real

The NTMA has correctly adopted a pragmatic approach to current bond market conditions. Issuance has been targeted where the perceived demand has been greatest (i.e. shorter-dated maturities), and the funding strategies have adopted a 'needs must' preference for size over spreads, bearing in mind that absolute borrowing costs remain at historically depressed levels (c.4% yields for both 2011 and 2014 offerings). The syndicated deals in January (2014) and February (2011) were both very well subscribed, raising €10bn or c.40% of 2009 funding needs.

The NTMA has also rolled out an auction calendar to tap existing bond issues over the remainder of this year. The first of these, a dual-dated tap of 2011 and 2020 maturities on March 24th, raised €1.3bn in total in the face of strong investor demand (bid/cover 3x). A programme of Treasury Bill issuance has also commenced, with reference dates between one- and 12-month maturities. The initial auction was successfully completed on March 26th, with €1.5bn raised via one-, three- and six-month offerings. Bearing in mind the NTMA's strong start-of-year cash balance of c.€21bn, courtesy of its $50bn Euro Commercial Paper (ECP) programme, those recent 'Ireland close to default' headlines have served no purpose for either commentator or country.

Sovereign funding pressures will persist, not least for the more 'vulnerable' Euroland sovereigns

There is no disputing that Euroland sovereign funding pressures will persist throughout 2009. Aggregate government bond supply will potentially exceed €1,050bn this year, compared with €625bn in 2008. Supply pressures will be reinforced by up to €1,600bn in government-backed bank debt issuance, together with a substantial pick-up in corporate bond issuance after the Lehman-induced hiatus. All such issues will be competing for funds in a marketplace where investor demand is still substantially impaired by the combined forces of deleveraging, balance sheet reduction and shrinking dealer networks.

As a small market (in index terms) with deteriorating fundamentals, Irish government bonds may be safely overlooked by global bond managers, irrespective of the yield spreads on offer. This is particularly the case where uncertainty is rife regarding the ultimate fate of the Irish economy, its banking system and, most acutely, its public finances.

Funding options

Ireland needs to tap its domestic investor base

Holdings of Irish government debt among both the domestic bank and non-bank public are relatively modest. With domestic savings on the rise as Ireland rebalances, a growing resource pool is now available to fund Irish borrowing needs. Irish institutional investors will doubtless be attracted by the absolute and relative yields available, while retail investors might also be targeted with a tax-efficient savings initiative (e.g. Solidarity Bond) in the national interest.

Support from the domestic banks may also grow in importance. Across the EU, commercial banks may be morally persuaded to raise their holdings of government bonds as a share of total assets (from c.3% currently) in order to ease pressure on their capital base. In time, this may even become a regulatory requirement by way of a *quid pro quo* for enforced state intervention in the banking system (note UK FSA proposals in this regard). Such bank holdings can be repoed-out, if necessary, at the ECB, thereby providing an indirect form of collective funding support for Euroland sovereigns.

Non-commercial funding sources may also be exploited

Ireland is committing €8bn per annum to the National Development Plan through 2013. It might be appropriate to ring-fence this capital expenditure from the rest of the Exchequer Borrowing Requirement and fund such borrowing from the EIB. The EIB can, in turn, finance these outlays from its general debt issuance programme, once again giving rise to a more collegial (if around-the-houses) EU support operation for a vulnerable member's funding needs.

Collective EU funding support may be rendered more explicit

In the most unlikely event that a "buyers strike" did confront any Euroland sovereign issuer, it is clear that mutual liquidity assistance would be rapidly forthcoming from EU sources. Such a collective display of solidarity within the EMU project could take a variety of forms, ranging from the "Bilateral Bond" musings of German politicians to the direct bond purchases of Eurosystem central banks. Although it is true that neither the ECB nor individual Euroland central banks can directly participate in primary bond issuance, they can happily support the secondary markets (and spreads) through reserve asset re-allocation. In addition, non-EMU official names may be swayed to assist the confraternity in the primary markets, if so required.

Prospective quantitative easing at the ECB would also offer support

Quantitative easing by central banks is rapidly assuming a global dimension, with the Federal Reserve, Bank of England and Bank of Japan now actively engaged in direct purchases of government securities. The ECB is understandably reluctant to follow this particular path. However, in a situation whereby the ECB decides to purchase government bonds, Euroland sovereign spreads will clearly tighten, given the central bank's imposition as strong marginal buyer. How the ECB chooses to allocate its bond purchases is open to conjecture, but it is a reasonable assumption that any allocation would not be to the detriment of those funding countries most in need.

The banking sector

How much capital is required?

With Irish GDP set to decline by at least 10% over the 2008-2010 period, and property prices already well below peak levels and still falling, quantifying the size of the hole that will be created in Irish banks' equity by loan impairments remains the key area of uncertainty. The ultimate capital requirement will depend on the time it takes the Irish and global economies to turn the corner.

We have combined the bank forecasts of our individual firms to create a consensus view of earnings and capital over the period. Our base case forecasts assume impairment levels over the next two years that are above the 'worst case' scenarios provided recently by the quoted Irish banks. Nevertheless, we believe that the risk to our bad debt assumptions remains to the upside, given the sharp and widespread deterioration in economic conditions evident in recent months.

Table 4: Summary forecasts for the banking system

	Allied Irish Banks	*Bank of Ireland*	*Other institutions*	*Total*
Loans	€129.5	€137.6	€141.1	€408.1
Bad debts 2008-2010 (€bn)	€9.0	€7.2	€8.3	€24.5
Bad debts/loans	7%	5%	6%	6%
Capital required to get to minimum equity tier 1 (€bn)				
Assume 4% minimum 2010 requirement	€0.8bn	€0.9bn	€1.0bn	€2.7bn
Assume 5% minimum 2010 requirement	€2.2bn	€2.0bn	€2.0bn	€6.1bn
Assume 6% minimum 2010 requirement	€3.6bn	€3.1bn	€3.1bn	€9.8bn

Calculations exclude preferred stock
Source: Davy; Goodbody; NCB

Our forecasts assume that the covered domestic banks incur loan losses of €25bn (or c.6% of the loan books) over the 2008-2010 period. We expect the level of loan losses to decline in 2011, while remaining well above normalised levels. At a system level, we expect core equity ratios to dip from c.6% at the end of 2008 to nearer 3.6% in 2010. We have excluded from our calculations the proposed €3.5bn investment by the state in preference shares in both Bank of Ireland and Allied Irish Banks — we do not believe that this is regarded as 'core equity' for loss absorption purposes as a going concern by equity investors, rating agencies or providers of term funding.

The level of capital the banks will need to hold at the back end of the cycle to satisfy both regulatory requirements and market expectations is another key uncertainty. This is in a regulatory environment that is in a state of flux and a market that remains cautious towards the banking sector. Our base forecasts imply that equity injections of €3bn, €6bn and €10bn would be required to raise the 2010 equity tier 1 ratios of the covered domestic banks to 4%, 5% and 6% respectively. This excludes any further capital that might be required should net trading losses extend into 2011.

Assuming that the covered banks incurred loan losses of 8% over the 2008-2010 period, rather than the 6% in our forecasts, would imply that €13bn in capital would be required to raise 2010 equity tier 1 ratios to 5%. Similarly, 10% loan losses over the period would imply €20bn in capital required to exit 2010 with a 5% ratio.

Recapitalisation options

Insurance scheme, bad bank or hybrid scheme

The Irish government is to inject €3.5bn in preference shares into both Allied Irish Banks and Bank of Ireland. As part of this plan, it will take warrants on 25% of the diluted share base. With the share prices of both stocks down over 40% since these proposals were announced on February 11th, it is clear that it has not succeeded in restoring market confidence.

In our view, more will have to be done. Indeed, according to the media, it appears that the government is already well down the path of looking at alternative options, in particular an AMC/bad bank, which will either complement the existing proposals or, more likely, replace them in whole or in part.

As government has effectively ruled out a straight equity injection, we are left with a number of options: an asset protection/insurance scheme, a 'bad bank'/AMC or some hybrid solution.

Ultimately, all achieve the same objective — the state is involved in the recapitalisation of the banking sector — although there are many differences. These include the timing of write-downs and hence what capital ratios look like, the level of capital needed up-front, what valuation is taken on property assets (economic or distressed market value) and who manages the problem assets etc.

Media reports suggest Bacon is recommending a single AMC

The UK has predominantly followed the insurance route (RBS and Lloyds Banking Group), which minimises the up-front capital injection from the government and utilises pre-provision profits to absorb losses as they occur over time. However, it is a slower process in terms of cleaning up bank balance sheets and ultimately the taxpayer foots the bill on extreme losses with no option to recoup any recoveries into the future.

We note media reports that suggest that the economist Peter Bacon has recommended to government an AMC-type structure. The details leaked so far are sketchy, but it is suggested that Bacon is proposing one central AMC that would issue government-backed debt (which can be repo-able into the ECB) to the banks in exchange for property assets acquired at a discount.

Centralising all problem assets into one vehicle in a small country has scale advantages and lends itself to dealing with problem clients on a portfolio basis — that is a huge advantage. For example, the PWC report on Anglo Irish Bank showed that the top 20 development and top 20 investment property exposures accounted for 25% of group loans.

However, we see a number of problems with a single structure:

- The biggest is how we get the parties to agree on what should be transferred and at what price. This is a complex task, further complicated by cross-collateralisation and multi-banking. In Securum's case in Sweden, they were dealing with a bank that had already been nationalised, while here we have a number of independent banks.
- A second problem relates to operational issues. While the AMC would be staffed with professionals from the property/investment and corporate finance sectors, one would also need to take people from the banks themselves who are familiar with the clients concerned, though not necessarily the people who initially granted the loans. Getting them to join a venture whose mission is to make itself redundant as quickly as possible would be no easy task.
- The venture would be dominant in the property market in Ireland for years to come and probably the only buyer of such assets. That is not ideal if one wants to achieve price discovery — but is still better than nothing. Having said that, it will restrict supply which should help prices stabilise over the medium term and support recovery values.
- It might be more difficult to shield a single AMC from political interference and controversy.

As such, a hybrid option for the banking sector may be some form of bad bank/insurance hybrid arrangement that would involve multiple 'work-out' vehicles/AMCs, but without the up-front crystallisation of losses. It would also have an insurance element in that the state would guarantee that capital ratios would not fall below a certain level.

Each bank would create a separate internal work-out unit or division; this would be consolidated within the group accounts, but with additional reporting of group performance excluding the division. These divisions would report to a separate agency — perhaps part of the Financial Regulator or NTMA — and policy on the selection of loans and how they are to be treated and valued would be coordinated by this agency. The agency would consist of local and international experts. The costs of running the agency would be apportioned to the banks relative to the value of impaired assets of each bank within their work-out units. So the core part of each bank would be able to concentrate on its 'good loans'.

In the lead-up to the creation of these units, a thorough analysis/stress-test would be required on each bank’s total loan book (with a case-by-case analysis of certain types of exposures and of all exposures over a set threshold), while also selecting loans appropriate for work-out units (transferred at current value). This analysis would be conducted independently and on a consistent basis across the banks, with a worst case level of losses being disclosed by each.

Pros and cons of each option

The insurance/asset protection option

Positives include:

- The up-front capital injection from government is either zero or lower than the bad bank option etc.
- It allows future pre-provisioning profits to cushion bad debts as they fall due.
- It provides certainty to the banks as second loss or tail risks are typically 90% covered by the state.
- Capital ratios in the early years can be flattered by treatment of the fee (Lloyds), if paid in shares — this is just optics, however.

Negatives include:

- Given EU rules and lowish capital ratios to start with, any such scheme for the Irish banks may require an equity injection to cover the first loss (as was the case with RBS).
- The Irish state takes on board an unfunded liability when the market is already sceptical that 'Ireland Inc' can pay its way.
- It leaves the management of problem loans in the hands of the banks, which may still be slow to take write-offs (only 50% of first loss goes against core tier 1) — i.e. moral hazard issues.
- Problem loans are too big and complex for the banks to manage alone, and they would distract management from day-to-day business.

The bad bank/AMC option

Positives include:

- Historic experience shows that bad banks are ideal vehicles to handle distressed property assets.
- The NPRF is 'cash in hand' that can cover the write-downs on transfer, together with some, if not all, of the capital required by the AMC to operate (at least day one).
- It allows property and corporate finance specialists to get the best value from the property assets and frees up the banks to focus on 'good banking'.
- It provides a quick fix with banks returning to profitability much more quickly.

Negatives include:

- It does not allow pre-provision profits to cushion bad debts as they fall due.
- It requires more government capital up-front than the insurance option as a large portion of losses is usually crystallised up-front — this presents a particular problem right now with share prices on the floor.

- There are questions as to whether it can be made operational in good time and whether the human capital resources are there to staff the one or more vehicles required.

Hybrid arrangement

Positives include:

- Recognition of losses as incurred means that pre-provision profits absorb some of the credit losses each year, limiting initial dilution, as per a bad bank. So government preference shares, or perhaps B shares, may convert as required each year to ensure targeted capital ratios are achieved. If share prices recover over the next two years, the scale of dilution diminishes materially.
- Loans remain on the balance sheet, thereby avoiding the need to issue new government-sponsored funding, which may possibly have knock-on implications for the sovereign.
- It allows the government to begin tackling the problem as the ECB and EU continue to consensually build their approach.
- It might be quicker to get up and running as human resources are already in place, unlike the bad bank proposal.

Negatives include:

- Loans are not taken off-balance-sheet or losses recognised up-front, so there is no clean break from the impaired loans and concerns that the banking system may continue to constrain capital and activity. However, this should be counteracted through a thorough stress test and disclosure of results.
- If banks still 'own' the assets, there may be control issues, with the work-out unit lacking independence.

The impact that the chosen solution has on the trajectory for the economy is equally important and empirical evidence would appear to suggest that the bad bank option is superior to the insurance option on this issue. Management at the Irish banks has a huge credibility problem with respect to their property books. Given how these assets weigh on the Irish economy, the preferred route from a capital markets perspective would be to take them off the banks completely and put them in a centralised vehicle, or move them into separate entities where specialist resources can be brought to bear on their management.

As we see it, there is a high probability that the government will have to take equity in the banks eventually, and it is probably better to do this as part of a process that removes the bad property loans altogether from the core operations of the banks. On this point, we note that the incoming preference share issues may provide a process for conversion into equity in due course, as has happened recently in the UK.

With equity investors, bondholders and taxpayers looking for greater clarity, sooner rather than later, the AMC appears best positioned to offer greater certainty in the short term, although this will probably involve government taking a slice of equity in Allied Irish Banks and Bank of Ireland. Therefore, it is important that the relevant parties move quickly to assess the full level of impaired and likely future impaired loans on balance sheets to provide input to the government's decision-making process on the most appropriate course of action.

Other suggestions

While the recapitalisation of the main banks is of paramount importance, these measures should be taken in conjunction with the following suggestions.

- The Financial Regulator should determine appropriate capital levels, which must be deemed acceptable by international capital markets since banks and the sovereign still have to fund on these markets.
- An outline work plan is required to get loan-to-deposit ratios for the mid- and smaller-sized banks down to market-normalised levels within an acceptable timeframe. Private equity involvement may be more appropriate here than in the case of the larger, more systemically important banks. Within this process, commercial property exposures should be reduced.
- Government needs to extend the liability guarantee out by a minimum of 12 months and must guarantee new term debt issues on a case-by-case basis. The guarantee should remain in place until necessary on short-term wholesale funding and deposits. Currently, there is too much maturing debt building up for September 2010.
- Consideration should possibly be given to centralising funding for a period. Moves to issue Irish government-sponsored paper would alleviate the de-stabilising effect of the weaker institutions coming to the market, notwithstanding the government guarantee. A cross-subsidisation arrangement could be put in place to normalise the costs.
- The banks could consider a debt buyback or debt-for-equity swap of their undated hybrid debt following the government re-capitalisation. Allied Irish Banks' and Bank of Ireland's c.€6bn undated tier 1 (non-core) and tier 2 debt instruments are currently quoted in a range of c.10–20% of par value. A swap for equity or buyback at a premium to current prices is surely a better option for most bondholders. It certainly would be for the banks in that, at a stroke, it would reduce balance sheet leverage and boost core equity.
- Improved regulation of financial services is required, with the principles-based approach to be superseded in time by a more detailed regulatory framework. There should be greater coordination between all the domestic regulatory bodies, and there needs to be more cooperation in Europe. The staffing levels of the Financial Regulator and related bodies need to be increased.
- There should be commitments to lend to the mortgage and SME sectors, although this must be framed in the context of the substantial downturn as we must not push good money after bad.

- Bad debt recoveries, as and when they arise, should largely go into general provisions to minimise cyclicality while remaining cognisant that equity levels also need to be improved.

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