Ireland

SEB Group – COUNTRY RISK ANALYSIS **March 15, 2019**

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Ireland's performance continues improving with the rate of economic growth being adjusted upwards for both the last and the current year. This is driven by the traditional economy as well as the multinational enterprises resident in Ireland. The boom has been accompanied by faster improvements than expected as regards the fiscal and external balances. However the looming risk of a disorderly Brexit could undo much of what has been achieved,

Country Risk Analysis

Summary and conclusions

Above expectations. Even though last year started with reasonably strong expectations for growth these were gradually raised even further ending at 6.5% for the whole year, up more than 2 pp (percentage points) on first estimates. This impressive development was driven by both domestic and external demand, including the multinational enterprises (MNE). Such trends are set to continue into the current year which should secure a growth rate around 3%. Last year unemployment dropped below 6% without much affecting overall inflation at less than 1%. In the housing sector, by contrast. surging demand caused prices of dwellings to soar 12%. Competitiveness remains solid as evidenced by a strong current account surplus.

Fiscal consolidation: In 2018, the government budget ended in a virtual balance helped in part by the sale of the government's stake in one of Ireland's largest banks the previous year. That supported a sharp drop in government debt to 64%/GDP although adjusted for the MNEs the number remained slightly above 100%.

Banks cleaning their balance sheets: Since the crisis in 2009-10 banks have seen profitability restored and the level of non-performing loans shrink to less than 12% from a peak of more than 25% in 2013. Although much reduced, at 140%/GDP household leverage is still high. Corporate leverage is even higher but that is in part related to the dominating foreign owned MNE sector.

Good performance set to continue: Over the last several years Ireland has shown an admirable strong record of fiscal consolidation and macro-economic management. Solid growth is set to continue in an environment of external surpluses and overall balanced budgets while deleveraging among households will continue.to improve banks' balance sheets. Main risks to such a scenario include the global economic environment in particular Brexit -- and the threat of a disorderly breakout from the EU by the UK, Ireland's by far largest trading partner. Additional risks include competing corporate tax regimes planned in other countries which could make Ireland less attractive to foreign capital. Most observers seem confident, though, that Ireland will prove resilient to such headwinds.

The sovereign has been upgraded to A-ratings by all major agencies. Recent improvements to both the economy and the country's finances are having a positive impact also on country risk with qualifications for what may happen with Brexit.

Recent developments

Growth beats expectations. Although last year started with reasonably strong expectations estimates for growth were gradually raised further as the year advanced ending at 6,5% for the whole year, more than two percentage points (pp) up from first estimates. This was driven by both domestic and external demand, including the multinational enterprises (MNE) which have relocated to Ireland in recent years. The latter have taken advantage of the recovery in the global economy, including Europe, while the traditional domestic economy have benefited from booming household demand in particular for homes. This boosted the construction sector resulting in a 30% increase of housing completion. Also services contributed significantly to growth acceleration while manufacturing turned out more sluggish. These statistics, however, comes with some qualifications because of the MNE sector. (Conf. Box 1.)

Box 1. The multinational enterprises: It has been noted that official statistics may overstate the underlying pace of growth. To help remedy the problem Ireland's statistical services have reconstructed national account estimates into Modified Final Domestic Demand (MDD). This series aims at stripping out the impact of MNE distortions by excluding investments in intellectual property and airplane purchases for leasing and shows that out of last year's 5% headline growth only 2pp were generated by domestic demand. The point is not that the MNE contribution to GDP was not real, but that the MNE sector is potentially subject to even minor variations in its operating environment -- tax codes and regulations –outside Ireland's control, and as such their contribution inherently hard to predict and estimate. Such abrupt changes in the annual statistics can also translate into gyrations in Ireland's external balances -- the current account and overall annual balance of payments numbers.

Good times continue: 2019 is expected to continue in the same tracks. Despite a small dip in January, PMI (Purchaser Management Index) still points to continued strong economic performance now also supported by strengthening consumer sentiment underpinned by jobs growth and rising real wages. Provided the global economy lives up to expectations, final growth numbers should tick in at some 3% before the end of the current year, although a slowdown, still clearly good growth.

Falling unemployment: Last year unemployment dropped further by 1 pp to 5.9% as employment continued to grow by almost 3%. Perhaps due to a still modest participation rate at only 60% of the working age population the tighter labor market has so far not affected nominal wages much. In 2017, they rose moderately by 1.7%, but that could change should growing wage demands from public sector workers succeed in 2019.

Stable prices except for housing: Consumer prices stood almost still in 2017, rising only 0.3% as measured by the CPI (consumer price index), This was only slightly above core inflation. In the housing market, by contrast, prices soared by almost 11% reaching some 40% above the trough of 2013, but still 30% below their pre-crisis peak in 2007.

Solid current account surplus set to continue: Since 2012 Ireland has been running a surplus on its external current account which last year ended at an exceptional 10%/GDP up 1pp from the preceding year. That was mainly thanks to growing exports of services from the MNE sector including IT and other high-tech products but also slowing imports. For the current year, expectations are for the surplus to moderate falling back to 4% as the slowdown of import growth is unlikely to persist.

Dominating capital flows: the internationalization of Ireland's financial sector shows up in large capital flows as resident banks repay old loans and refinance new ones. Last year total external gross debt ended at €827bn, almost three times greater than annual GDP, As regards the total balance of payment position vis-à-vis other Eurozone members, Ireland showed a small net asset position in the Target2 balances, testament to market confidence in the country's overall economic and regulatory policies.

Policies

Another year of fiscal over-performance: Since the budget exploded during the height of the crisis some ten years ago with a deficit exceeding 32%/GDP -- including recapitalization of the banking system, though – governments of various colors have persevered with consolidation policies. These were last year crowned with the balance ending in a small deficit at 0,3%/GDP – unchanged from the previous year – thanks to strong revenues and the privatization of the largest domestic bank, AIB, for more than 1%/GDP. The government also succeeded in rationalizing expenditures which at 3.6% grew less than budgeted. As a result of these achievements it is now expected that for the current year the government should be able to sustain the gains and end with a balanced budget. That will be a couple of years earlier than first planned.

Repaying debt: The budget over-performance enabled the government to pre-prepay emergency loans granted during the 2008/10 crisis thereby settling a total of €5.5bn. debt to the IMF and the governments of Denmark and Sweden which could now be refinanced cheaper on market terms. In 2017, the spread to Bunds fell by a half to less than 40bsp and in last October the Treasury could issue new debt at a negative yield. Prices of CDS swap have also come down sharply to levels comparable with high A-rated sovereigns. That has helped the government's raise its cash buffer to almost 4%/GDP, more than sufficient to cover its annual gross refinancing needs. The terms of such refinancing have gradually become quite benign with lower prices an an extended maturity of ten years on average despite the sovereign still being indebted at 64%/GDP in 2018. (Another oft-cited number, 100%/GDP, excludes the activities of the MNEs in the denominator.)

The 2019 budget follows in the same tracks: The budget for the current year has been presented with a small deficit of 0.2%/GDP – statistically speaking this is a virtual balance. That will see headline debt drop further to 62%/GDP thanks to continued healthy economic growth. The government recently changed its mind about building a "rainy day" fund, and will instead spend more on infrastructure, including railways and roads. The question is, however, if the country has the required resources including labor to accomplish this without eventually trigger unwanted wage inflation.

Banks: Last November credit growth was still slightly negative – about 0.2% yoy – following several years of rapid deleveraging by corporates and households. In contrast, and despite the shrinking loan books, the level of NPLs (non-performing loans) continued to fall to less than 12% of total outstanding from a peak of 26% in early 2016. That improvement was in large part testament to the stronger economy which has boosted the repayment capacity of many borrowers. It was also a response to the new government's effort to promote work-out programs. Partly as a result of this, but also in response to recent improvements to banking supervision and regulations, capital tier 1 ratios last year strengthened to 25%.

Leverage still high: However, the legacy of the crisis lingers on. At 142%, household debt to disposable income remained high at the end of 2016 but has since declined at a rapid rate. In early 2017, rising house prices had cut mortgages "under water" to less than 12% from almost 40% at the height of the Eurozone crisis in 2012. . The situation for the corporate sector may look even worse with corporate debt at 215%/GDP as reported in mid-2017, but these numbers are clearly inflated by the expansion of the MNEs

Structural policies: Ireland scores high on almost every structural aspect. Lack of reforms was not the cause of the economic and financial crisis almost ten years ago but rather hubris and weak macro-economic management that ended in a credit boom and subsequent overheating. The rapid rise of the MNE sector also contributed to the pre-crisis overheating. Nevertheless, Ireland has upheld its attractiveness to multinational foreign companies first and foremost by offering a favorable tax and regulatory regime.

Politics

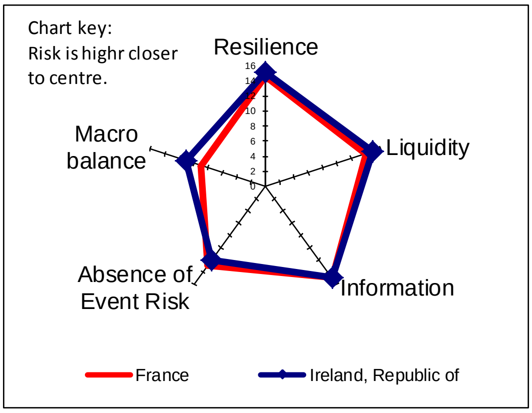
Next elections must be held by early 2021. Recent opinion polls show rising support for the largest party represented in Parliament, the centrist *Fine Gail*, which has led a minority government since inconclusive elections in 2016. It was eventually formed with the tacit support of the second largest party, *Fianna Fail.* Were this support to collapse it would likely prompt new elections at short notice.

Outlook:

Over the last several years Ireland has shown an admirable strong record of fiscal consolidation and macro-economic management. Steady growth is set to continue in an environment of external surplus and overall budget balance. Deleveraging among households will continue but at a more moderate pace than seen in recent years. As a result, banks' balance sheets should improve further.

Main risks to such a scenario include the global economic environment, in particular Brexit. The UK is Ireland's closest trading partner but so far Irish exports have not been much hurt by the economic worries of the UK or the weakening pound. The other main risk is that of competing corporate tax regimes being introduced by other countries. The recent cut of company taxes in the US is a case in point. But with the economy now stabilized, most observers appear to believe that institutional and regulatory strength has improved to a point where the country should be able to weather also such headwinds.

Key ratios	**2019**
Population (millions)	5,7
GDP/capita ($)	81639
GDP (change)	2,7%
Inflation	1,8%
Curr.acc. balance/GDP	4,0%
Reserves/imports (months)	0,03
Budget balance/GDP	0,0%
Government debt/GDP*	62%



External ratings:
Fitch: A+
S&P: A+
Moody's: A2.

Peers:
Lithuania
Korea
France

Graph: Like France, Ireland is strong on on fundamentals (resilience, liquidity, macro balance). Event risk is abating as banks are gradually growing out of their underlying problems.

Appendix

Brexit -- the end-game in progress?

Having had her Brexit agreement voted down in Parliament on March 13 PM Theresa May is left with only two options before the official Brexit deadline, March 29:

- Do no more but accept defeat and a disorderly break-out from the EU
- Or rather ask for an extension to the deadline

The first is frequently cited as a worst case scenario that could cost the UK a short but sharp slowdown, probably meaning a technical recession (two consecutive quarters of negative quarter-on-quarter growth) and only a slightly positive year-on year growth of less than 1%. Other countries would also be impacted, in particular Ireland for which the UK represents some 12% of total exports. Contagion working through investor and consumer sentiment might also have non-negligible spillover effects pulling down EU growth by some 0,4pp (percentage points) and global growth by at least 0,2pp relative to a smooth-Brexit scenario.

The second – ask for an extension -- is at present time the most likely being the only option that can garner Parliamentary support over the remaining two weeks. The only uncertainty about that option is that it could be blocked by any EU member country. The argument for denying the UK an extension, is that EU might hate to be seen as compromising its own negotiating position after having gradually given some ground in recent Brexit negotiations although repeatedly asserting that there was no more to give.

However, the likelihood of such a rejection has recently been reduced by the weakening of European growth expectations since late 2018. Eurozone growth for the current year has been adjusted down to 1,6% spearheaded by stuttering German growth reduced to 1,1% following an average of 2% annual growth since 2017, More ominously, Italy may experience no growth at all this year potentially jeopardizing investor confidence. A Brexit crisis on top of that could trigger a new euro crisis.

Such could soften any hawkish posturing in Brussels towards Brexit. While the French President, Mr. Macron, has become an increasingly dogmatic EU standard bearer, the more pragmatic German Chancellor, Ms. Merkel, recently held out her hand for a three months extension. The rationale for that would probably be to give the fire-head *Brexiteers* in the UK Parliament time to cool down.

What makes Brexit so difficult?

First time a country – and that being one of the three largest in EU, is taking advantage of Article 50 of the EU charter to exit the union. The rest of the EU would not like to see that setting a precedence of this being an easy option.

That is even more so as the UK is not acting in an emergency but rather for reasons including the free movement of people within the union, which it could have foreseen when signing up for membership in the first place.

Backstop: The Irish Republic is clearly the country most exposed to Brexit. The so-called *Backstop* deal from late 2018 aims to take care of some of those concerns, but has now become a sticking point. The Tories of the ruling UK Conservative party see this part of May's Brexit deal as encroaching on the UK sovereignty over Northern Ireland. The Good Friday Agreement of 1999 that ended two decades of terrorism and civil war in the territory is sometimes mentioned in this context as if any partial closing of the border with Ireland could have a bearing on that agreement.

<u>Domestic UK politics</u>: As a member of the EU UK must accept the free movement of people inside the EU. There is no doubt that the growing inflows to UK of often less well-educated people from other parts of the EU, including the new members of Eastern Europe, have caused social frictions that no British party can ignore. That came to a head during the refugee crisis in 2015. However, many observers, including inside the Conservative Party itself, are seeing this rather as a cause célèbre for rallying around the conservative party. In a recent interview on CNN of March 10, Mr. George Osborne, the Chancellor of the Exchequer for the previous Conservative Cameron government until 2016, explained his party as searching for a mission lost since Thatcherism in the 1980s. In that vein Brexit has become the heart and soul of the Tories, now even exacerbated by their fear of a much radicalized *Labour* which could win next elections. While those are not due before 2022 and announcing a winner is pure speculation at this stage, should any blame for an accidental Brexit fall on the Conservative party UK politics may be set for a crucial change for many years going forward.

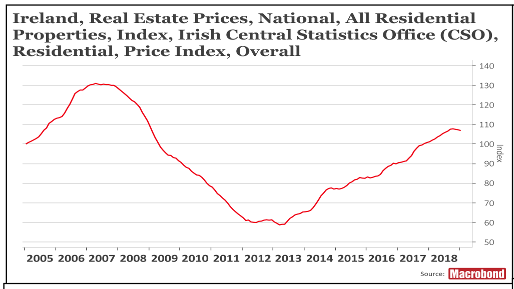
Key data:	2012	2013	2014	2015	2016	2017	2018	2019	2020
GDP (bill. US$)	225	239	259	291	302	332	374	398	424
GDP/capita (US$)	49040	51888	56074	62019	63501	69350	77414	81639	86208
GDP (change)	0,2%	1,3%	8,7%	25,0%	4,9%	7,2%	6,5%	2,7%	2,3%
Investments/GDP	20%	19%	20%	24%	36%	23%	21%	21%	21%
Budget balance/GDP	-8,0%	-6,1%	-3,6%	-1,9%	-0,5%	-0,3%	-0,3%	0,0%	0,3%
Govt debt/GDP*	119%	118%	101%	70%	71%	66%	64%	62%	59%
CPI inflation (%)	1,7%	0,5%	0,2%	-0,3%	0,0%	0,3%	0,5%	1,8%	1,8%
Money demand (%)	-8,1%	0,7%	-1,1%	8,6%	7,7%	3,3%	-1,4%	6,7%	5,1%
Stock prices	3185	4041	4850	6210	6142	6784	7016		
Interest rates	0,6%	0,2%	0,2%	0,0%	-0,3%	-0,3%	-0,3%	-0,1%	0,3%
Exch. Rate ($)	1,28	1,33	1,33	1,11	1,11	1,13	1,18	1,22	1,25
Trade/GDP (%)	95%	91%	96%	109%	103%	94%	95%	97%	96%
Oil price (Brent)	$112	$109	$99	$52	$44	$54	$75	$77	$73
billions US $									
Export of goods&services	130,8	130,9	151,7	221,8	213,5	217,8	260,0	261,6	275,7
Imports of goods&services	83,4	85,2	97,7	96,3	96,4	96,2	110,7	124,0	130,9
Other:	-53,4	-42,0	-51,2	-112,6	-129,7	-92,7	-113,7	-121,6	-128,3
Current account	**-6,0**	**3,6**	**2,8**	**12,9**	**-12,5**	**29,0**	**36,1**	**16,0**	**16,5**
(% of GDP)	-2,7%	1,5%	1,1%	4,4%	-4,2%	8,7%	9,7%	4,0%	3,9%
FDI	19,6	12,4	-11,7	45,4	-23,0	10,1	-19,1	-19,8	-20,5
Loan repayments	-68,8	-42,5	-18,6	-108,4	-63,3	-59,1	-63,0	-67,8	-71,7
Net other capital flows	54,9	26,5	27,6	50,6	99,4	20,6	63,3	72,7	76,5
Balance of payments	**-0,3**	**0,0**	**0,0**	**0,5**	**0,5**	**0,6**	**0,6**	**1,1**	**0,8**
Reserves	0,0	0,0	0,1	0,6	1,1	1,7	2,3	3,4	4,2
Total debt	686	685	635	858	851	867	853	843	829
o/w short term debt	316	295	292	275	349	390	324	320	315

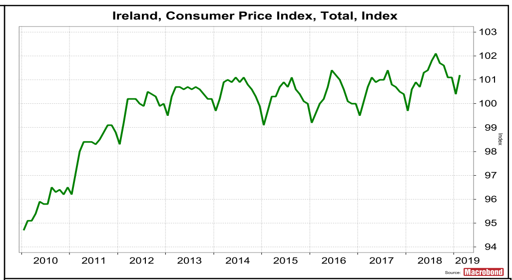
Sources: Oxford Economics and SEB estimates.

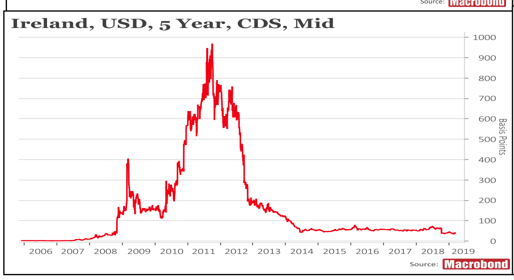
*Excluding NAMA liabilities

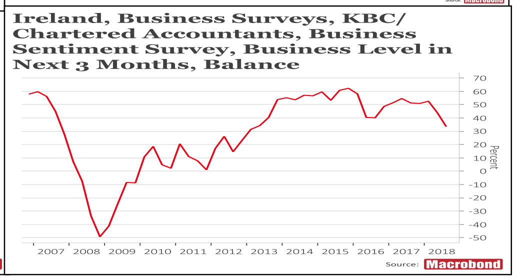
Rating history						
Fitch (eoy)	BBB+	BBB+	BBB+	A-	A	A+
Moody's	Ba1	Ba1	Baa3	Baa1	A3	A2

Type of government:	Parliamentary Democracy
Next elections	Presidential elections in October 2018. Parliamentary elections 2021
Other:	
Latest PC deal	None
Latest IMF arrangements	2010 - 2013









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