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Market Commentary
December 14, 2010

Ireland: Economic Developments and Update

Overview

- ***After contracting by some 4 percent in 2009 from 2008 with gross domestic product (GDP) growth contracting 1.8 percent in Q3:2010, setting the country further apart from other major economies in the eurozone, the Irish economy is expected to recover to pre-crisis levels in three years at the earliest.***

- ***For 2010, growth is projected at 0.3 percent growing a further 1.7 percent in 2011. Over the medium term, growth is projected to remain below 2 percent, slower than before the global financial crisis, but is expected to reach roughly half of pre-crisis YoY growth of 2.6 percent in Q4:2011.***

- ***With support of both the International Monetary Fund (IMF) and the European Commission, the Irish government recently approved the first technical measures of the 2011 austerity budget aimed at rescuing the country from a burgeoning deficit and prevent economic collapse.***

- ***With Irish banks facing a liquidity crisis and the greater threat of regional contagion looming (Portugal, Spain, Italy), the European Union approved the 85 billion-euro (US$113 billion) bank bailout package under the Joint EU/IMF Programme to cover losses realized by the country's banking system. The expectation is that this will help prevent both national economic collapse and systemic sovereign debt defaults in the region.***

- ***After a 2 percent increase in value from August, the current trade balance posted a surplus of 3.91 billion-euro (US$5.36 billion) in September, up from 2.5 billion euro (US$3.3 billion) in January. The core of Ireland's recovery will be export-led, with exports expected to rise by 6 percent over last year, according to the country's National Recovery Plan. This will be the key driver of the Irish recovery story and will include widening its export markets beyond Europe and the U.S. to emerging market countries, which now contribute to close to half of global GDP growth.***

Macros

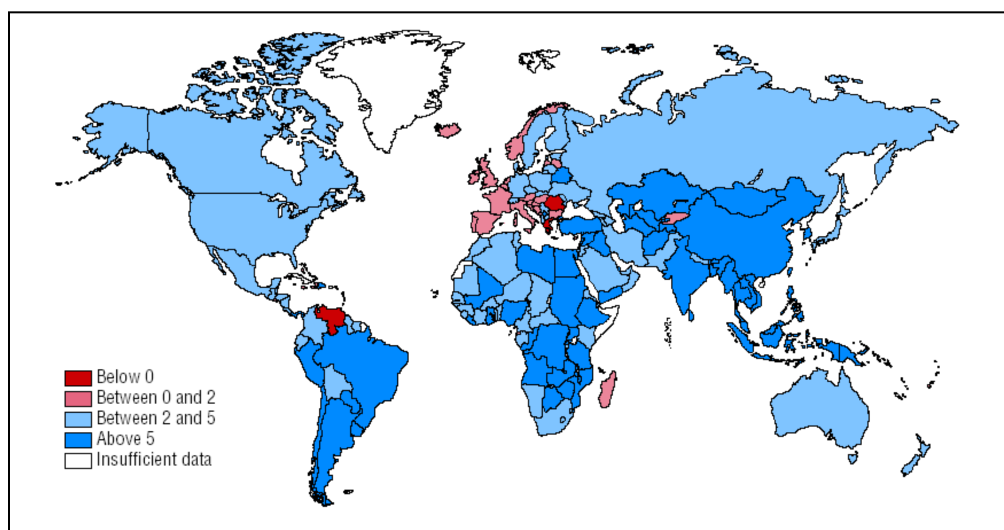
Running a surplus on the eve of the current crisis, Ireland is now running a budget deficit; and is in the process of stabilizing (what may have been a toxic Celtic Bubble fallout) and recovering from its deepest recession in the postwar period. Following a 4 percent contraction in 2009, GDP is projected to increase by .3 percent in 2010 and 1.7 percent in 2011. Ireland's economic downturn had been expected in Q3:2010 mainly because of the recent global economic and European banking crisis (some analysts say, private sector bubble and runaway banking crisis). The effect is likely to be short-lived and contained.

The sovereign troubles that surfaced in Q1:2010 shook regional confidence, which was in the process of stabilizing an already weak financial system. Emerging markets survived the recession better than advanced Europe. While emerging economies are projected to reach pre-crisis growth levels in the near-term, advanced Europe is projected to grow by only 1.7 percent in 2010 and 1.6 percent in 2011. This is important because emerging market economies could lead Ireland out of the crisis if the Irish State will focus its efforts on expanding its burgeoning export sector to developing countries in need of hi-tech imports.

As the euro weakened, gold soared, and stock markets tumbled in advanced Europe, emergency policy actions helped contain the problem and the recovery endured. The lingering impact of the crisis will demand active fiscal adjustment in 2011 from regional governments. Despite recent strength, the upswing in advanced Europe is projected to remain weak by historical standards especially compared with emerging markets, which will exit from the global financial crisis in the driver's seat, becoming more important global players.

However, the recovery, helped by the trailing effect of fiscal stimulus and a sustained global effort to rebound from the crisis, has gained firm momentum. The outlook is broadly positive. Governments will expand the macroeconomic policy tool kit and enhance the effectiveness of monetary policy. Growth in almost all European countries will be positive next year. This is in stark contrast with 2009, when only Albania, Belarus, Israel, Kosovo, and Poland saw positive growth.

Figure 1 Average projected real GDP Growth during 2010-11
(Percent)



Source: IMF staff estimates
Calculations: Nova Capital Partners

Table 1. European Countries: Real GDP Growth and CPI Inflation, 2007-11
(*Percent*)

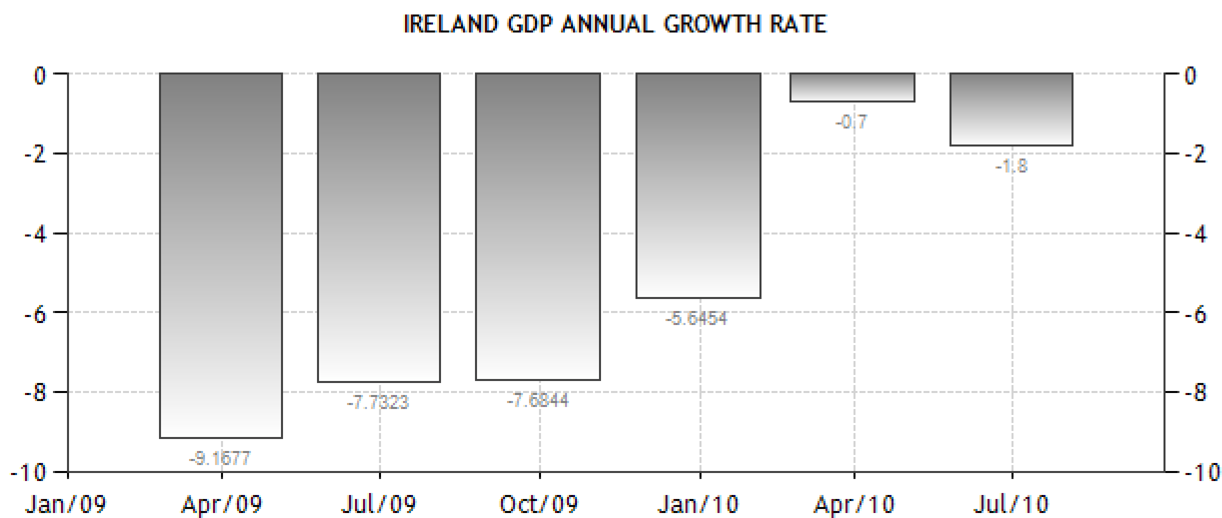
	Real GDP Growth					Average CPI Inflation				
	2007	2008	2009	2010	2011	2007	2008	2009	2010	2011
Europe[1]	4.0	1.4	-4.6	2.3	2.2	3.6	5.7	2.7	2.9	2.8
Advanced European economies[1]	3.0	0.5	-4.0	1.7	1.6	2.1	3.4	0.7	1.8	1.7
Emerging European economies[1]	7.0	4.1	-6.0	3.9	3.8	7.8	12.0	8.5	6.1	6.1
European Union[1]	3.2	0.8	-4.1	1.7	1.7	2.4	3.7	0.9	1.9	1.8
Euro area	2.9	0.5	-4.1	1.7	1.5	2.1	3.3	0.3	1.6	1.5
Austria	3.7	2.2	-3.9	1.6	1.6	2.2	3.2	0.4	1.5	1.7
Belgium	2.8	0.8	-2.7	1.6	1.7	1.8	4.5	0.0	2.0	1.9
Cyprus	5.1	3.6	-1.7	0.4	1.8	2.2	4.4	0.2	2.2	2.3
Finland	5.3	0.9	-8.0	2.4	2.0	1.6	3.9	1.6	1.4	1.8
France	2.3	0.1	-2.5	1.6	1.6	1.6	3.2	0.1	1.6	1.6
Germany	2.7	1.0	-4.7	3.3	2.0	2.3	2.8	0.2	1.3	1.4
Greece	4.5	2.0	-2.0	-4.0	-2.6	3.0	4.2	1.4	4.6	2.2
Ireland	5.6	-3.5	-7.6	-0.3	2.3	2.9	3.1	-1.7	-1.6	-0.5
Italy	1.5	-1.3	-5.0	1.0	1.0	2.0	3.5	0.8	1.6	1.7
Luxembourg	6.5	0.0	-4.1	3.0	3.1	2.3	3.4	0.4	2.3	1.9
Malta	3.7	2.6	-2.1	1.7	1.7	0.7	4.7	1.8	1.9	2.1
Netherlands	3.9	1.9	-3.9	1.8	1.7	1.6	2.2	1.0	1.3	1.1
Portugal	2.4	0.0	-2.6	1.1	0.0	2.4	2.7	-0.9	0.9	1.2
Slovak Republic	10.6	6.2	-4.7	4.1	4.3	1.9	3.9	0.9	0.7	1.9
Slovenia	6.8	3.5	-7.8	0.8	2.4	3.6	5.7	0.9	1.5	2.3
Spain	3.6	0.9	-3.7	-0.3	0.7	2.8	4.1	-0.2	1.5	1.1
Other EU advanced economies										
Czech Republic	6.1	2.5	-4.1	2.0	2.2	2.9	6.3	1.0	1.6	2.0
Denmark	1.7	-0.9	-4.7	2.0	2.3	1.7	3.4	1.3	2.0	2.0
Sweden	3.3	-0.4	-5.1	4.4	2.6	1.7	3.3	2.0	1.8	1.9
United Kingdom	2.7	-0.1	-4.9	1.7	2.0	2.3	3.6	2.1	3.1	2.5
EU emerging economies[1]	6.0	4.4	-3.0	1.6	2.9	4.6	6.5	3.9	3.2	3.1
Bulgaria	6.2	6.0	-5.0	0.0	2.0	7.6	12.0	2.5	2.2	2.9
Estonia	6.9	-5.1	-13.9	1.8	3.5	6.6	10.4	-0.1	2.5	2.0
Hungary	1.0	0.6	-6.3	0.6	2.0	7.9	6.1	4.2	4.7	3.3
Latvia	10.0	-4.2	-18.0	-1.0	3.3	10.1	15.3	3.3	-1.4	0.9
Lithuania	9.8	2.8	-14.8	1.3	3.1	5.8	11.1	4.2	1.0	1.3
Poland	6.8	5.0	1.7	3.4	3.7	2.5	4.2	3.5	2.4	2.7
Romania	6.3	7.3	-7.1	-1.9	1.5	4.8	7.8	5.6	5.9	5.2
Non-EU advanced economies										
Iceland	6.0	1.0	-6.8	-3.0	3.0	5.0	12.4	12.0	5.9	3.5
Israel	5.3	4.2	0.8	4.2	3.8	0.5	4.6	3.3	2.3	2.8
Norway	2.7	0.8	-1.4	0.6	1.8	0.7	3.8	2.2	2.5	1.4
Switzerland	3.6	1.9	-1.9	2.9	1.7	0.7	2.4	-0.5	0.7	0.5
Other emerging economies										
Albania	5.9	7.7	3.3	2.6	3.2	2.9	3.4	2.2	3.4	2.9
Belarus	8.6	10.2	0.2	7.2	6.2	8.4	14.8	13.0	7.3	10.8
Bosnia and Herzegovina	6.1	5.7	-3.1	0.5	3.0	1.5	7.4	-0.4	2.4	2.5
Croatia	5.5	2.4	-5.8	-1.5	1.6	2.9	6.1	2.4	1.9	2.8
Kosovo	4.0	5.4	4.0	4.6	5.9	4.4	9.4	-2.4	1.7	3.2
Macedonia	6.1	5.0	-0.8	1.2	3.0	2.3	8.3	-0.8	1.9	3.0
Moldova	3.0	7.8	-6.5	3.2	3.5	12.4	12.7	0.0	7.4	6.0
Montenegro	10.7	6.9	-5.7	-1.8	4.5	4.2	8.5	3.4	0.6	1.0
Russia	8.5	5.2	-7.9	4.0	4.3	9.0	14.1	11.7	6.6	7.4
Serbia	6.9	5.5	-3.0	1.5	3.0	6.5	12.4	8.1	4.6	4.4
Turkey	4.7	0.7	-4.7	7.8	3.6	8.8	10.4	6.3	8.7	5.7
Ukraine	7.9	2.1	-15.1	3.7	4.5	12.8	25.2	15.9	9.8	10.8

Source: IMF, World Economic Outlook database
Calculations: Nova Capital Partners

Market Overview

Ireland is a small, modern, and innovative trade-dependent economy with an Anglo-Saxon legal system, domestically educated English-speaking workforce, strong FDI incentives and a low tax regime. GDP growth averaged 6% in 1995-2007, but economic activity dropped sharply in 2008 and Ireland entered into a recession for the first time in more than a decade with the onset of the world financial crisis and subsequent slowdown in domestic demand and investments. The export sector, dominated by foreign multinationals, remains a key component of Ireland's economy. With nine successive quarters of declining real GNP, the Irish indebted economy contracted a further 1.8 percent in the third quarter of 2010, as measured by the year-over-year change in Gross Domestic Product (GDP YoY). The Ireland Gross Domestic Product is worth US$227 billion or 0.37% of the world economy, according to the World Bank. From 2002 until 2010, Ireland's average annual GDP Growth was 2.53 percent reaching an historical high of 8.13 percent in September of 2002 and a record low of -9.17 percent in March of 2009 (see Table 2).

Table 2. Ireland GDP year over year growth rate
(Percent)



Source: Trading Economics
Analysis and Calculations: Nova Capital Partners

A slowdown in Ireland's economic recovery was accompanied by a budget deficit of roughly 2.1 percent of GDP in the first 10 months of 2010 and bank liquidity crisis and a deflated property market coinciding with the banking crisis Ireland reported a current account deficit equivalent to €1142.0 in the second quarter of 2010 (see Table 3).

Faced with the threat of sovereign default, and the resultant loss of confidence by investors in European banks (even more so than in their U.S. competitors), the Irish government took sweeping measures to stabilize its economy by downsizing, restructuring, and recapitalizing its banking system, approving the 85 billion-euro (US$113 billion) bank bailout package from the European Union and the International IMF. This EU-IMF bailout (of foreign bank creditors) will cover losses realized (and unrealized) by the country's banking system and prevent both national economic collapse and systemic sovereign debt defaults in the region.

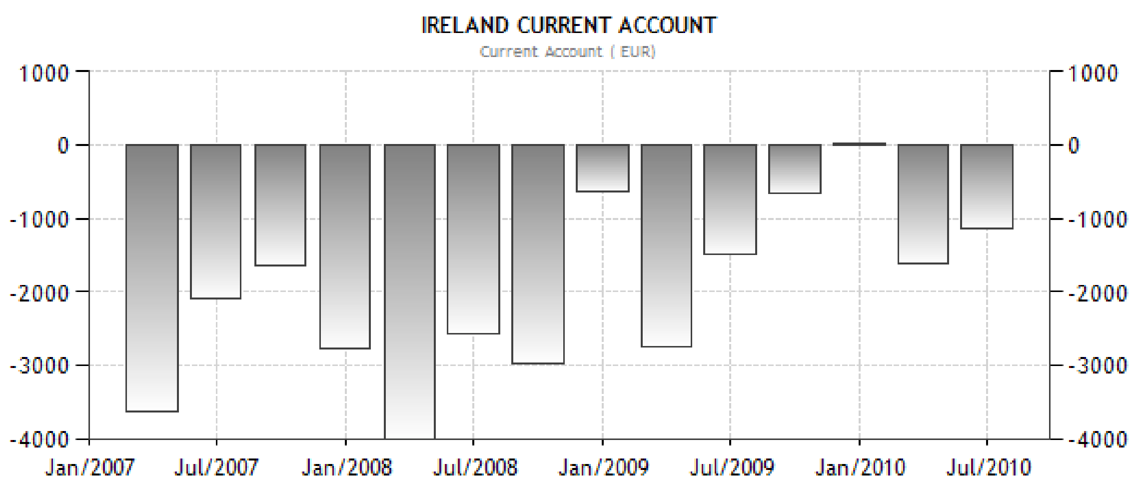
The Euro 85 billion support from EU-IMF will ensure that this is done sooner rather than later, providing a proxy for euro area sovereign bond restructuring.

One example of the State's downsizing is the EBS deal that is on the table. Fearing that Ireland had turned itself into a large insolvent bank (and the ECD had essentially failed to bail that bank out), the Irish Central Bank said in November that the country's banks will have to increase their capital levels and that Dublin-based EBS, one of Ireland's largest financial institutions and the largest building society, must raise an additional 438 million euros ($577 million) to maintain financial strength. The Irish government is seeking to sell EBS to reduce lenders' reliance on the State. WL Ross, the New York-based leveraged buyout firm, is part of an investor group bidding for EBS that includes Washington-based private equity firm Carlyle Group and Dublin-based Cardinal Asset Management. That group and Irish Life & Permanent Plc were selected on Oct. 22 as the final EBS bidders, according to Bloomberg data.

The auction of EBS or other financial institutions or assets in the future will be an important step in restoring confidence of foreign investors in Ireland's banking sector and the ability to attract continued FDI in the private sector in general. Similar to what happened in the US, the banking sector's real estate lending portfolios will need to be restructured or auctioned off in order to give the banks' the ability to begin to lend again to the critical property market.

Staving off a downward spiral and default primarily through a restructuring of the Irish banking system and the introduction of a series of fiscal and structural reforms, the recovery in Ireland will find a boost with the resurgence of the world's and the Eurozone's advanced economies and growing strength of the emerging economies, which now contribute to close to half of global GDP growth. Global GDP growth is approaching pre-crisis growth rates (4.8 percent in 2010 and 4.2 in 2011), and Irish exports are benefiting. Export growth is especially strong in countries that export capital goods, which had earlier seen a very steep drop in external demand.

Table 3. Ireland current account
(Percent)



Source: Trading Economics
Analysis and Calculations: Nova Capital Partners

Rebound drivers

Exports remain the primary engine for Ireland's robust growth. Reflecting the important role of Ireland's foreign-owned exporting sector, Ireland has achieved the highest trade surplus relative to GDP in the euro area. Ireland exports mainly agri-food, cattle, beef, dairy products, zinc, lead and aluminum. Ireland's major imports are: data processing equipment, chemicals, petroleum and petroleum products, textiles and clothing. European Union is by far its largest trading partner, accounting for about 74% of exports and 60% of imports. Other major partners are U.S. and China. The State will need to focus on opening new doors in emerging market economies, which are growing at a much faster clip than European economies.

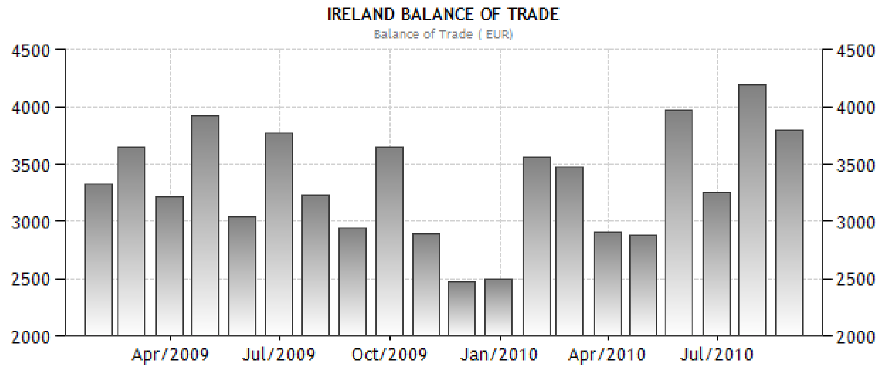
Irish export performance impressed again in September with a 9% increase in value from Q1:2010 while the country's seasonally adjusted trade surplus rose by over €1 billion to €3.91bn.

Table 4. Ireland exports
(EUR)

Source: Trading Economics
Analysis and Calculations: Nova Capital Partners

Ireland's trade surplus grew by almost three percent in September to €3.91 billion ($5.36 billion) with an increase in both exports and imports, according to recent official data. Exports increased by two percent to €7.79 billion while imports increased by 1.0 percent to €3.89 billion and are forecasted to grow by 2.7 percent for the year. The Central Statistics (CSO) said the value of exports in September was up by 4.0 percent compared with September 2009, while the value of imports was up by 7.0 percent. The data released by the CSO gave final figures for August and first estimates for September.

Table 5. Ireland balance of trade
(EUR)

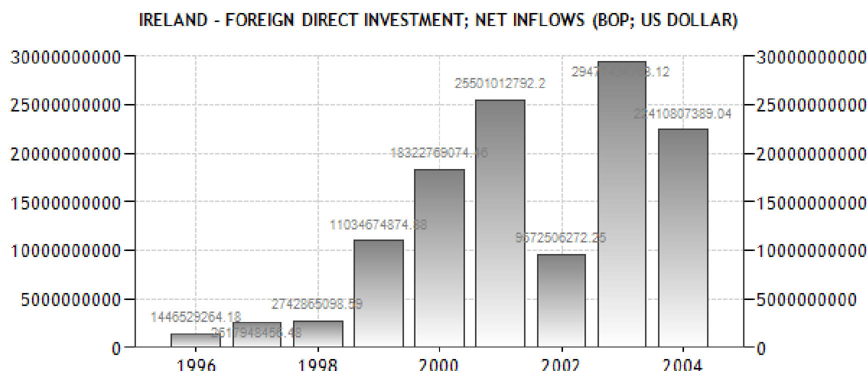


Source: Trading Economics
Analysis and Calculations: Nova Capital Partners

Latest external trade figures published by the CSO show import value rose by 1% between August and September; while on an unadjusted and YoY basis the value of exports was up by 4% in September, while import value rose by 7%. Also on an unadjusted basis, Ireland's trade surplus rose to just under €4.2bn for the month. Volume increase is expected around 7.5%, for 2010 and 6.5% for 2011 in goods and services exports, while the overall merchandise trade surplus will break through the €40bn level this year. Recent CSO figures also showed that the value of Irish exports — over the first seven months of the year grew by 2% year-on-year to €58.2bn; while import value fell by the same percentage to €29.8bn.

Ireland's export strength is closely tied to its foreign direct investments (FDI). Nearly 70 percent of its exports are created by companies that have arrived in Ireland through FDI channels from 1996 to 2004 (see Table 6). An estimated 50 percent of the workforce in the country is employed by these exporters. Although faced with pressure from other eurozone countries (like France and Germany) to raise its corporation tax to provide a level playing field for other EU partners, the Irish government is using caution when negotiating any upward revision in its 12.5 percent corporate tax, which could have been a major detriment in attracting FDI into the country – and has thus far managed to preserve its low tax rate in its negotiations with the EU and IMF.

Table 6. Ireland foreign direct investment
(USD)



Source: Trading Economics
Analysis and Calculations: Nova Capital Partners

Conclusion

Ireland's post-crisis (immediate) growth strategy will focus on the austere budget, designed to bring the government finances under control, and the fundamental problem of restoring Ireland's competitiveness in the international financial markets. This will be accomplished by tackling the insolvency issue not through harmful restructuring of the financial sector—most analysts argue reconfiguration and downsizing of the banks is recommended—but by a concerted effort toward boosting exports and output to the advancing emerging economies of the world, which will help the indebted country close their fiscal and current-account deficits. (A second primary focus should be based on investment in the infrastructures needed by the Irish State for future growth, such as attracting foreign investments for renewable energy installations across the island, which will create jobs.)

The Irish government's future competitiveness policy should focus on expanding and diversifying its export orientation with sustained efforts toward supporting export enterprises in higher-tech industries, particularly into those markets that are growing strongest—mainly, the emerging markets, which are driving the global recovery. For example, Ireland exports goods to the value of €3.3bn to Asia, and has grown these exports by 3%. Rapid growth will need to occur here, with special attention given to widening the door of trade to China and India, which certainly could use more of Ireland's hi-tech industries. Currently, Ireland has the largest number of U.S. FDA-approved plants outside the U.S. Perhaps Ireland could inform and then persuade other high tax regimes in developing countries to do the same? Food, retail and logistics also account for a sizeable portion of its export today. The food and drink sectors should also be a key focus where Irish-owned firms have a comparative advantage, as well as information technology and pharmaceuticals.

By focusing on higher-tech industries, Ireland won't be competing with emerging market economies where there is less an export opportunity and more a competitive threat. Given that Ireland is an open, non-protectionist, globalized economy—a trading and export-driven country which relies heavily on both the talent and productivity of its industrious people and business friendly laws and tax regime (with the ability to turn private debt into tax-payer obligations)—we estimate a full recovery in roughly three years when growth will reach pre-crisis levels as a result of loan growth, loose fiscal policy, stability in the financial sector, and increased exports to emerging markets.

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