European Views

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Ireland: Confronting the problem

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While the situation in Ireland remains severe, the government (and the Irish public more generally) have shown an impressive resolve in responding to the economic and budgetary crisis. Fiscal policy has already been tightened by 5% of GDP in the past year and the 2010 Budget—to be announced tomorrow (3.45pm LDN)—is expected to tighten policy by a further 2½% of GDP. Although the government, the opposition and the trade unions continue to debate *where* and *how* the knife should fall, there is little or no dispute about *when* and *how much* the budget should be cut. This contrasts with the situation in a number of other European countries where, despite similar budget problems, there appears to be a reluctance to acknowledge—let alone confront—the problem.

Dealing with loss

Elisabeth Kübler-Ross, the Swiss psychiatrist, set out five stages in the process of dealing with loss: denial, anger, bargaining, depression and acceptance. In the process of coping with its economic loss, Ireland appears to be somewhere between Stage 4 (depression) and Stage 5 (acceptance). By contrast, a number of other Euro-zone economies, in similar positions to Ireland, appear to be stuck somewhere between Stage 1 (denial) and Stage 2 (anger).

The loss that the Irish people have had to contend with has been severe: with growth and tax revenues that were heavily skewed towards the housing sector during the boom years, the impact from the crisis—on the banking sector, on budgetary finances and on the economy more generally—has been dramatic. From a peak in 2007Q1, real GDP has declined by 10.5% (double the Euro-zone peak-to-trough decline of 5.1%); the government budget balance has moved from a surplus of 3% of GDP in 2006 to an estimated deficit of 12% this year, and the banking sector as a whole has teetered on the edge of bankruptcy.

While the progression from European outperformer to underperformer has been sudden, the Irish government (and the Irish public more generally) have been quick to come to terms with the severity of the crisis, and have displayed considerable resolve in implementing painful changes to address the problems.

The government has already tightened the fiscal stance by 5% of GDP in the past year and there is cross-party agreement to implement a further 2½% of GDP (€4bn) tightening in the 2010 budget (to be announced tomorrow). As part of the public-sector retrenchment, public-sector employees have already taken a 7-8% pay cut and have accepted the need for additional 'temporary' cuts. The latest media indications are that almost all of the €4bn adjustment to be announced in tomorrow's budget will be made on the expenditure side, and will include a further 5-6% cut in public-sector pay, a 4% cut in social welfare payments, and a 9-10% cut in child benefit. Factoring in these adjustments, we expect the budget deficit to be 12% of GDP this year, between 11½ and 12% next year, and then to fall sharply thereafter.

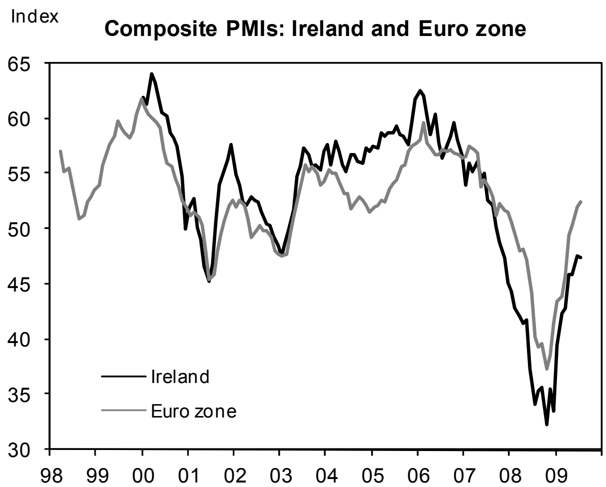
These moves are not without controversy and there remains a heated debate between Ireland's government, its opposition and the trade unions. Importantly, however, the debate is focused on *how* and *where* the cuts should be made, not on *whether* or *when* the consolidation should take place. The unions have called for public-sector expenditure to be reduced through unpaid leave (rather than pay cuts) and for a greater emphasis on increased taxes for the well-off. But they do not challenge the need for budgetary adjustment. Meanwhile, opinion polls imply strong support for sharp public-sector cuts.

All of this is in marked contrast with the situation in countries such as Greece, Spain and Portugal.

The Irish economy: Showing signs of stabilisation

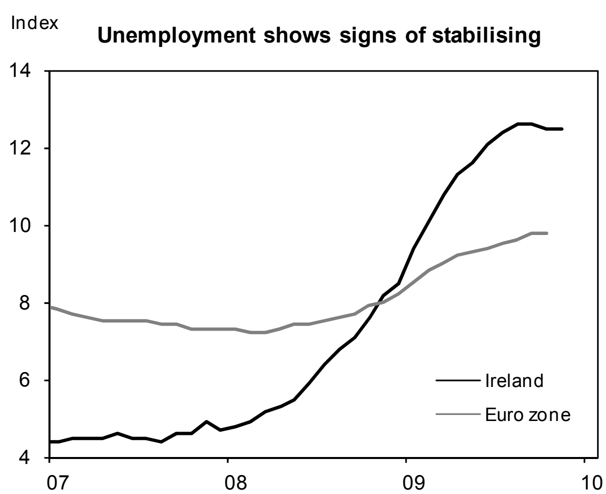
The latest information on the Irish economy is also encouraging.

- Business surveys such as the Composite PMI, while still below the Euro-zone average, have risen to a level consistent with sequential growth (Chart 1).



Source: Markit

- Unemployment appears to be stabilising. Having reached 12.6% in August, Ireland's unemployment rate stood at 12.5% in November (Chart 2).



Source: Markit

- The latest income tax returns are encouraging. In particular, the November data—an important month for returns—came in well ahead of expectations.

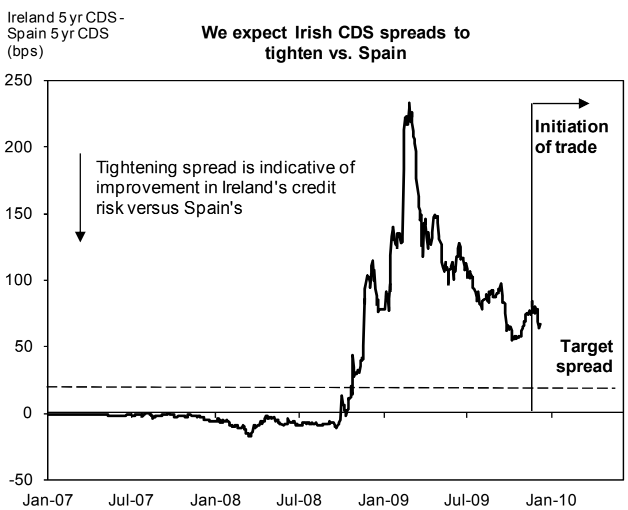
Relative to consensus, we are constructive on the economic outlook: we expect Ireland's growth to be -0.5% in 2010 and +2.9% in 2011.

Long 5-yr credit protection on Spain, short 5-yr credit protection on Ireland

Government bond and CDS spreads imply that the market views the risk on Irish bonds as broadly equivalent to Greece, and significantly higher than either Spain or Portugal. Our own view is that this relative pricing is unwarranted.[1] While the economic and budgetary situation in Ireland remains severe, we are constructive on Irish assets vs. Spain, Portugal and Greece. This is principally because Ireland has displayed much greater resolve in tackling the fall-out from the crisis.

The other key factor is the restructuring of Ireland's banking sector. On this issue—which we have discussed in previous notes—we are also relatively optimistic: the government has implemented a 'bad bank' solution (NAMA) in the face of considerable opposition. In our view, this represents a speedy and effective way to clean up the banks' balance sheets.

Reflecting these considerations, our Global Markets team is recommending Long 5-yr credit protection on Spain, short 5-yr credit protection on Ireland as one of its Top Trades for this year (Chart 3).



Source: Bloomberg, GS calculations

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1. Although Irish bond and CDS spreads have risen in recent weeks, they remain much tighter than they were earlier this year. We also argued at that stage that they should tighten. See "Ireland: Sovereign spreads are too high but urgent fiscal correction is required", *European Weekly Analyst*, February 26, 2009.

I, Kevin Daly, certify that neither the views expressed in nor timing of this Publication has been influenced by knowledge, if any, of firm or client positions in the relevant security or currency.