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Research Report: Irish economy

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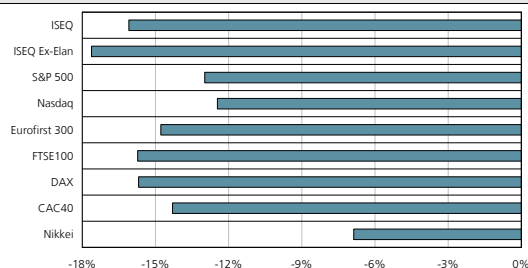
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Weekly Market Comment

No problem for Ireland to breach deficit limit temporarily

International returns ytd (€)



Forecast revisions

	2008		2009	
	Prev	Rev	Prev	Rev
Ryanair	18.2	2.8	34.2	14.4

Forthcoming results and events

Tuesday June 10th

Live register (May)

Wednesday June 11th

Independent News & Media - AGM - Park Lane Hotel, Piccadilly, London, W1J 7BX - 12.00

Thursday June 12th

Ormonde Mining - AGM - Conrad Hotel, Earlsfort Terrace, Dublin 2 - 11.00

TVC Holdings FY results

Consumer price index (May)

Retail sales index (Apr)

Friday June 13th

Index of employment in construction (Apr)

Reversal of property market windfall has caused the short-term hole in public finances

- In 2005-2006, the government benefited from windfall receipts from the property market. However, property-related revenue is now almost back to where it was four years ago due to the drop in new housing sales and lack of transactions in the commercial arena.
- Instead of a Budget surplus, the country is now faced with a significant annual deficit. We reckon that tax revenue will undershoot the official Department of Finance forecast by €3bn in 2008.

Theoretically, Ireland is bound by 3% annual deficit limit

- As part of the euro, Ireland has to meet its obligations under the Maastricht treaty.
- This has one constraint: the general government (all arms of the state) is not supposed to run an annual deficit of more than 3% of GDP. The problem is we think that deficit limit will be approached in 2008 and breached in 2009 unless the government acts.

Strong case to argue for some temporary fiscal leeway

- But we have a compelling case to make for a temporary breach to finance our capital programme.
- Ireland is still running a current Budget surplus: tax revenue will exceed day-to-day spending in 2008. The deficit results from borrowing to invest in infrastructure. That investment will make the public finances more sustainable in the long run.
- From a balance sheet perspective, Ireland stands out. Its debt ratio is the second-lowest in the euro area at 25% versus an average of 66.3%.

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No problem for Ireland to breach deficit limit temporarily

Ireland's short-term fiscal position is deteriorating. Consequently, the debate is starting to rage about what the government might do to patch the holes. The only reason for the clamour to cut back on expenditure (or to raise taxes) is that Ireland is – on paper and as part of the euro – bound by the 3% deficit limit in a calendar year. But the most important policy now is to protect our capital investment programme. Because of our low government debt ratio in both relative and absolute terms, we have a strong case to argue for some leeway to breach the deficit temporarily in 2009.

Reversal of property market windfall has caused the short-term hole in public finances

Our public finances are reeling from the property downturn. This situation is the reverse of a few years ago. In 2005-2006, the government benefited from windfall receipts as transactions in the residential and commercial property market reached frenzied levels. Property-related revenue is now back to where it was four years ago due to the drop in new housing sales and lack of transactions in the commercial arena.

Instead of a Budget surplus, the country is now faced with a significant deficit. We reckon that tax revenue will undershoot the official Department of Finance forecast by €3bn in 2008.

Theoretically, the Department now needs to fill a funding gap. In the last couple of weeks, the government has flown the kite of potential amendments to the National Development Plan (NDP). Yet its exact intentions have been deliberately vague. Note that the plan is worth €184bn over six years to 2013, but it's not all about roads, rail and buildings: almost half of the NDP – €84bn – is current spending. The government is not going to announce imminently that day-to-day expenditure on the public sector will be cut. When the pay talks are out of the way, however, it may clarify its position.

On paper, Ireland is bound by 3% annual general government deficit limit

As part of the euro, Ireland has to meet its obligations under the Maastricht treaty. The fiscal rules have morphed into the Stability and Growth Pact. This has one constraint: the general government (all arms of the state) is not supposed to run an annual deficit of more than 3% of GDP. The problem is that we think that deficit limit will be approached in 2008 and breached in 2009 unless the government tweaks something.

One idea currently being floated is to take a break from our contributions to the National Pensions Reserve Fund (NPRF). This, however, is a total red herring. These contributions do not affect the general government balance because the NPRF is a part of government as far as the European Union is concerned. It would be like moving funds from one subsidiary of a company to another. The internal positions change, but the bottom line of the company does not.

So what can we actually do? Let us start with what would be the biggest policy mistake: cutting capital spending under the NDP. First, the plan continues the massive investment in our capital stock that will boost productivity and therefore overall welfare for current and future generations. Second, construction needs a lift. Apart from civil engineering, the rest of the industry is suffering. We need to bolster activity in this area to create some jobs and prevent a further hit to the economy.

Strong case to argue for some temporary fiscal leeway

There is another option. Why not breach the 3% deficit limit temporarily? Of course, there is a precedent: Germany missed the limit in both 2004 and 2005. In fact, its deficit totalled 3.7% of GDP four years ago before falling to 3.4% (still offside) the following year.

Ireland could present its strong case to Brussels as follows. In 2008, we will take in more in tax revenue than we will use in everyday spending. In other words, we are still running a current Budget surplus. The only reason we have a deficit overall is that we are spending so much on infrastructure in order to catch up with the rest of Europe. Every company invests in order to grow. In fact, if we improve our productivity through investment, our public finances will be more sustainable in the long run.

The other important criterion under Maastricht is that government debt ideally must be limited to 60% of GDP, although it does not bring censure if that target is exceeded. We have a starting debt ratio of 25.4%. France, which is likely to surpass the 3% limit this year, has a ratio of 64.2%. Moreover, France is not running an annual current surplus, and its dependency ratio (the number of people outside the working age group as a proportion of the working age population) is far higher than that of Ireland.

But are the government or the mandarins in the Department of Finance brave enough to take this option? They may feel that doing so is like going 'cap-in-hand' to Brussels and therefore unpalatable politically. However, if it is good enough for Germany and France to do so, from a much weaker position, then why not for Ireland? After all, it is within the rules to breach the limit if it is "temporary and exceptional". Moreover, if Ireland was a company, it would not have enough debt. The investment case is more compelling than ever.

Table 1: General government debt % of GDP (2007)

France	64.2
Germany	65.0
Italy	104.0
Spain	36.2
Euro area	66.3
EU-27	58.7
Ireland	25.4

Source: Eurostat

Important disclosures

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