



December 8, 2010

Research Report: Irish economy

Robbie Kelleher

robbie.kelleher@davy.ie / +353 1 6148916

Barry Dixon

barry.dixon@davy.ie / +353 1 6148922

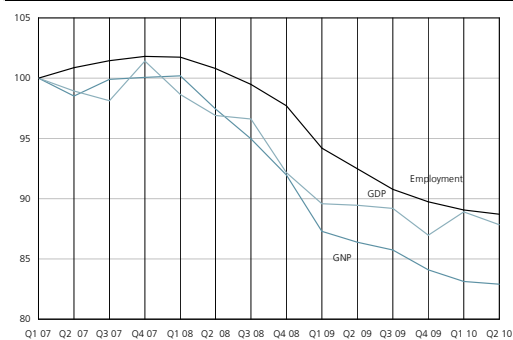
Conall Mac Coille

conall.maccoille@davy.ie / +353 1 6148770

Budget 2011

After the big freeze, now for the big squeeze

Is the Irish economy bottoming?



Source: CSO

The arithmetic is clear enough

- There was little new in yesterday's budget. The recently published National Recovery Plan and the memorandum of understanding agreed with the EU and IMF had already revealed what the government intended to do to restore balance to the public finances.
- Over the next four years, there will be cumulative 'adjustments' of €15bn in budgetary measures: €10bn in spending cuts and €5bn in tax increases.
- This amounts to a cumulative reduction of 12% in nominal terms in current spending and a whopping 43% reduction in capital spending. Tax revenues meanwhile are slated to increase by 35%.

But can the economy handle it?

- Putting the numbers into columns and rows is straightforward enough, but is it reasonable to expect the economy to grow in the face of such fiscal retrenchment?
- It is certainly possible. The UK is attempting a similar mission and the international forecasting community still expects reasonable growth there over the period. And Ireland itself did it before in the 1980s.
- The big difference this time around is the mountain of private sector debt and a dysfunctional banking system. Hence, the need to follow these fiscal plans with measures to downsize and re-capitalise the banking system must now take top priority.

Please refer to important disclosures at the end of this report.

Davy is regulated by the Central Bank of Ireland and is a member of the Irish Stock Exchange, the London Stock Exchange and Euronext. Davy is authorised by the Central Bank of Ireland and regulated by the Financial Services Authority for the conduct of business in the UK. All prices as of close of previous trading day unless otherwise indicated. For the attention of US clients of Davy Securities, this third-party research report has been produced by our affiliate, J & E Davy.

The long road back

In recent years, the main contents of the annual exchequer Budget were usually well signalled in the media in advance. This year, the content of the budget was even better known before the Minister started to speak yesterday. In early November, the Department of Finance published an information note on the budgetary and economic outlook for the period 2011-2014. That was followed by a detailed National Recovery Plan for the same period in late November (see our research report '[National Recovery Plan 2011-2014](#)', issued November 25th), which in turn was followed by an even more detailed memorandum of understanding associated with the €85bn funding arrangements agreed with the International Monetary Fund (IMF) and European Union (EU). So, it was always unlikely that yesterday's statement would contain any great surprises.

But before we review the targets as they now stand, it is worth reminding ourselves just how we arrived at a situation where fiscal balances are so large and apparently intractable.

Table 1 below summarises the broad developments between 2000 and 2007.

Table 1: How we got into this mess (€m)					
	2000	2007	% change 2000-2007	2009	% change 2007-2009
Current expenditure	25,918	52,544	103%	60,723	16%
Pay	8,883	17,745	100%	20,113	13%
Capital expenditure	5,096	10,385	104%	15,039	45%
Total	31,014	62,929	103%	75,762	20%
Current revenues	33,309	60,169	81%	48,632	-19%
CPI			30%		-1%
Government balance	4,923	346		-23,350	

Source: Department of Finance

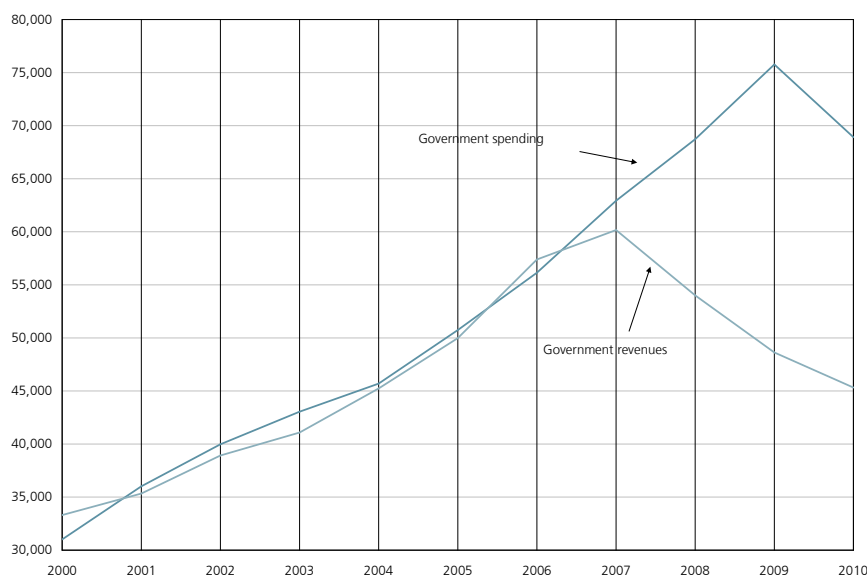
Over that seven-year period, public expenditure more than doubled, with similar increases across a broad range of categories, including the pay and pensions bill. That compared with an increase of 30% in consumer prices over that period. Public spending was growing at a rate in excess of 10.5% per annum while prices were increasing at an annual rate of less than 4%.

True revenue did increase rapidly over that period as well as a buoyant economy swelled the coffers of the Exchequer — but not as rapidly as spending did. So the overall government balance went from being in sizeable surplus (almost 5% of GDP) in 2000 to being just about in-balance in 2007. At the height of the boom we were allowing ourselves a very modest cushion indeed.

What happened in the following two years is in many ways even more remarkable. As we all now know, tax revenues collapsed with the collapse of the building sector and a sharp weakening in the economy as a whole. But expenditure continued to increase, partly as a result of a first injection of €4bn in capital into Anglo Irish Bank.

That left the government with an overall deficit of over €23bn, more than 14% of GDP.

Figure 1: Emergence of the gap — diverging trends in revenue and expenditure



Source: Department of Finance

The arithmetic of the road back

In arithmetic terms, the solution to the problem is clear enough: it has to be some combination of falling expenditure and rising revenues.

What is planned over the next few years is summarised in Table 2.

Table 2: The way back (% change)

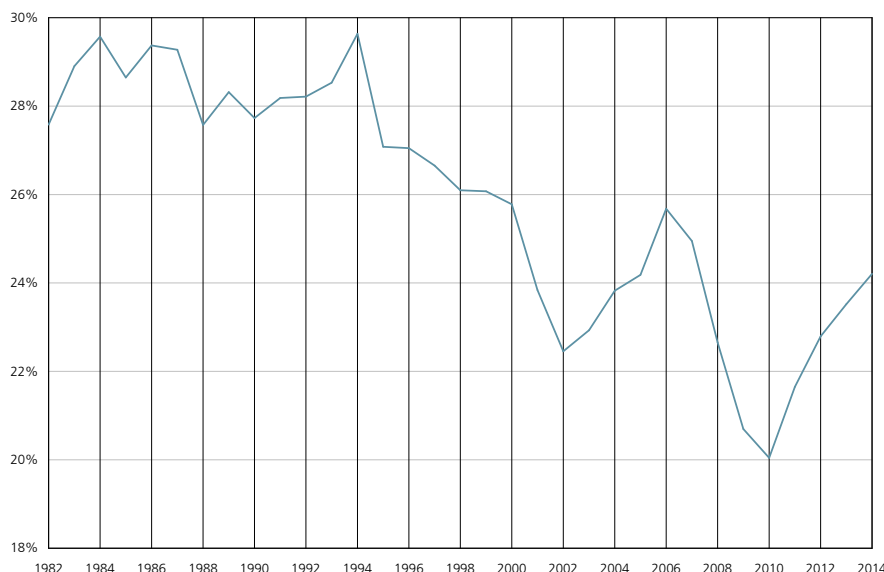
	2011	2012	2013	2014	Cumulative 2010-2014
Current spending (exc. interest)	-3%	-4%	-3%	-3%	-12%
Pay bill	-1%	-2%	-2%	-1%	-5%
Capital spending	-25%	-8%	-9%	-10%	-43%
Tax revenues	4%	10%	8%	8%	35%
Government balance (€bn)	-15.2	-12.3	-10.2	-5.2	
% of GDP	-9.4%	-7.3%	-5.8%	-2.8%	

Source: Department of Finance

Current spending (excluding interest payments) is set to fall by 12%, although within that the pay bill is set to fall by just 5%. The big axe falls on capital spending, down another 43% over the period, having already fallen by over 30% between 2008 and 2010. By 2014, capital spending will have fallen by 61% from its 2008 peak.

On the tax side, receipts are expected to increase by 35% over the period. About half of this will come from specific tax increases and a similar amount is expected to come from the buoyancy of the economy.

Figure 2: The rising tax burden (taxes as % of GDP)



Source: Department of Finance

Can the economy handle this?

But is it reasonable to assume that an economy can shoulder such a withdrawal of government support and still manage to grow? The cumulative 'adjustments' amount to €15bn over the four years and that is equivalent to 12% of GNP in 2010.

The official forecasters seem to think so, as is outlined in Table 3.

Table 3: Official forecasts (% change)					
	2010	2011	2012	2013	2014
Real GDP	0.3%	1.7%	3.2%	3.0%	2.8%
Real GNP	-2.0%	1.0%	2.6%	2.4%	2.4%
Employment	-4.0%	-0.2%	1.3%	1.6%	1.8%
Unemployment rate	13.4%	13.2%	12.0%	10.9%	9.8%

Source: Budget 2011

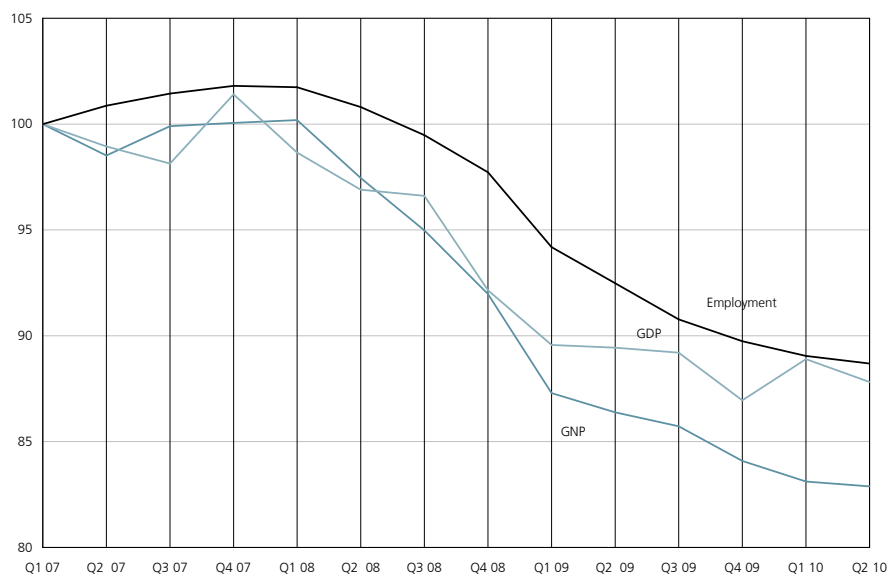
After stagnating in GDP terms in 2010, the economy is expected to grow again next year and to be expanding at a 3%+ pace by 2012. That is seen as sufficient to result in employment growth resuming and the unemployment rate falling to less than 10% by 2014.

On the face of it, these seem like optimistic projections given the magnitude of the fiscal correction that is underway. But the expectation for 2011 is in line with consensus expectations.

Beyond that, a number of points should be borne in mind:

- The UK is proposing a similar fiscal consolidation over the next few years and it expects decent economic growth over the period. That expectation is not hugely contested by the international economic consensus.
- Last year, the budget correction in Ireland amounted to €4bn, yet it appears that the economy managed to stabilise during the year.

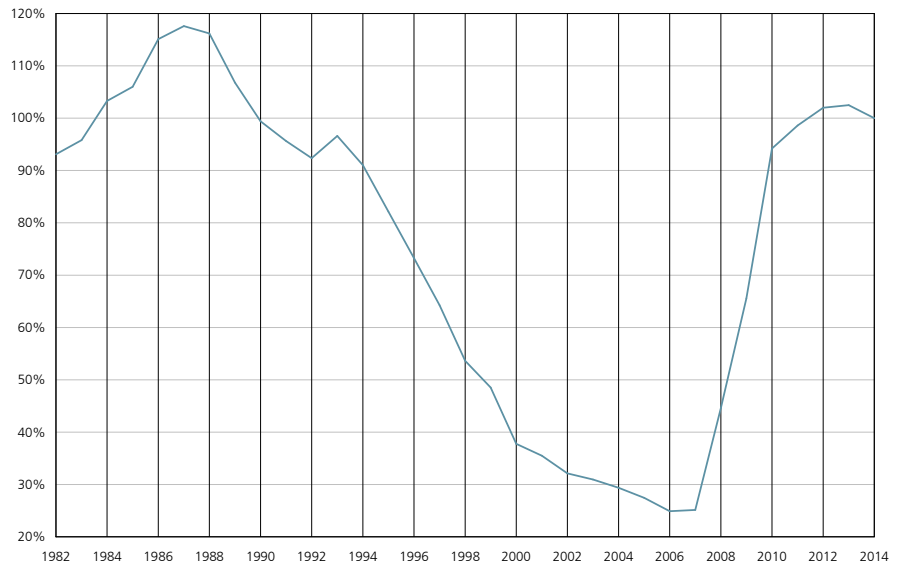
Figure 3: Is the Irish economy bottoming?



Source: CSO

- Back in 1987, public expenditure was reduced by 7% in real terms, yet the economy was growing at a rate of 6% within two years.
- Finally, the overall debt ratios in Ireland are undoubtedly demanding but they were higher in the 1980s and the economy survived. In the 1980s, the debt/GDP ratio reached almost 120%. This time, it is expected to peak at around 100%.

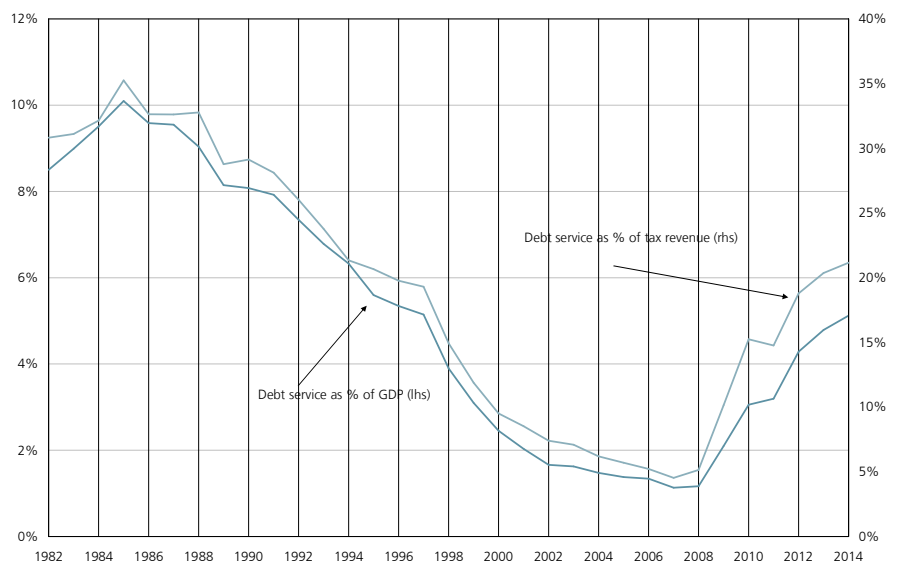
Figure 4: The burden of debt (government debt-to-GDP ratio)



Source: Department of Finance

The debt service ratio was much higher as well: it reached almost 10% of GDP and 35% of tax revenue.

Figure 5: Debt service ratios (% of GDP and % of tax revenue)



Source: Department of Finance

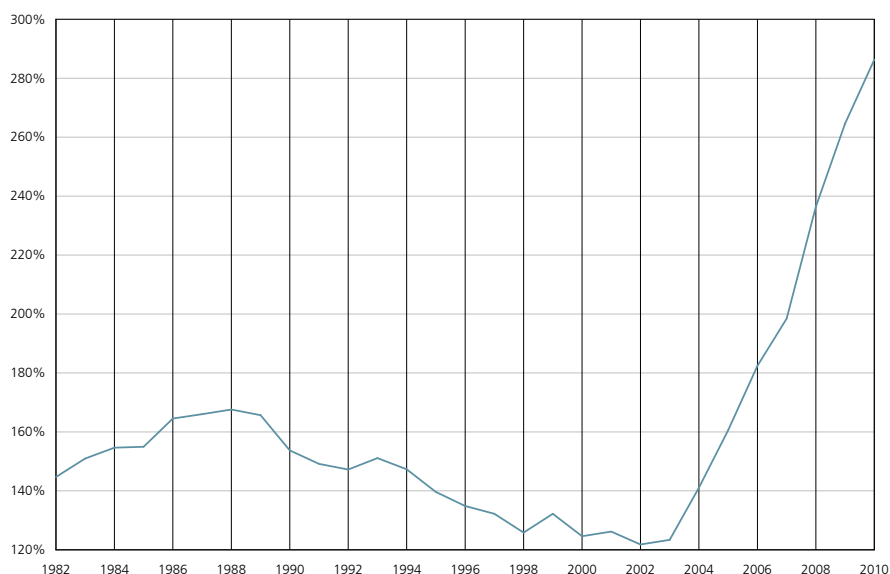
The elephant in the room: banks and private sector debt

The foregoing charts would suggest that if the problems were confined to the government finances they would be challenging but probably manageable.

But as we have painfully seen this year, the fiscal problems have been hugely compounded by an oversized and deeply impaired banking

system. The counterpart of this, of course, is a private sector that is heavily indebted. That is what it is different from the 1980s.

Figure 6: Total debt is much higher than in 1980s (public and private debt/GDP)



Source: Department of Finance, Central Bank of Ireland, CSO

In the 1980s, private sector debt was about 50% of GDP; now it is close to 200% of GDP. As a result, the overall debt ratio is almost twice what it was in the 1980s.

Hence, the most important influence on whether the current fiscal journey is successful or not will probably be how soon and how well the authorities achieve their aim of downsizing and finally fully re-capitalising our banking system. In that respect, the early months of 2011 will tell a lot.

Tax measures forecast to yield €2.0bn in revenues

The taxation adjustments in Budget 2011 were as expected, with most of the key measures following the National Recovery Plan (NRP) published in November. Taxation changes are expected to account for just one-third of the overall €15bn budgetary adjustment set out in the NRP. Of the €6bn of adjustments in yesterday's budget, just €2.0bn in the full year comprises changes to taxation and PRSI. The focus in the budgetary adjustment on the expenditure side should be commended. And as was well flagged ahead of the budget, there were no changes to the corporation tax rate, maintaining a key support to the economy's prospects for growth.

10% reduction in tax credits and bands yields €1.1bn

The taxation changes focussed on incomes and pension contributions. Income tax forms the largest part of the adjustment, following a 10% reduction in the value of tax credits and bands. These measures are expected to raise €1.1bn in 2011. Given that 45% of the workforce were exempt from income tax prior to the budget, the reduction in tax credits and bands was an unavoidable measure, and should help to broaden the tax base.

Table 4: Impact of budget on 2011 fiscal position (€m)

Total budget package	6,000
Income tax	1,054
Value added tax	14
Corporation tax	21
Capital acquisitions tax	27
Stamp duties	-36
Excise duties	33
PRSI	296
Total tax and PRSI	1,409

Source: Government estimates

PRSI changes will add almost €300m

Changes to PRSI are expected to raise €296m in 2011. The abolition of the ceiling on PRSI is expected to raise €100m in 2011 and €145m in a full year, while the increase in the PRSI rate from 3% to 4% for the self-employed is expected to raise €53m in 2011, and €80m in a full year.

Employee pension contributions will now be subject to PRSI. Employer PRSI relief on employee pension contributions is being reduced by 50%. And the annual earnings limit for employee/personal contributions is being reduced to €115,000 for 2011. In total, changes in the taxation of pensions are expected to raise €117m in 2011, and €235m in a full year. There have also been significant reductions in the entitlements in tax-free lump sums.

Stamp duty changes may not be sufficient to reignite housing market

On a brighter note, the budget included a reduction in the stamp duty rate to 1% on properties valued up to €1m, and 2% on those over €1m. This initiative is expected to cost €36m in 2011 but should be welcomed given the depressed conditions in the housing market. That said, we expect that broader macroeconomic conditions will remain key, so a recovery in housing market conditions is unlikely in the near future. But the reduction in the stamp duty rate removes an obstacle to an eventual recovery.

Savers will be less happy. The rate on deposit interest retention tax (DIRT) was increased by 2% on both ordinary and long-term deposit accounts; this is expected to raise €22.5m in 2011 and €30m in a full year. The minimum threshold for capital gains tax (CGT) is being reduced by 20% which is expected to raise €40m in a full year.

Current expenditure cuts of 4% focused on social welfare and health

The expenditure cuts outlined in Budget 2011 of €2,192m are slightly below the €2,221m outlined in the NRP. Cuts in social welfare payments account for €873m, or almost 40% of the total savings. Reductions in health spending account for a further €746m (34%), while education accounts for €170m, or almost 8% of the total. Together therefore, these three line items account for over 80% of the proposed savings. The balance comes from a range of other measures spread across different government departments.

Table 5: Spending cuts by department (€m)

	<i>2010 budget forecast outturn</i>	<i>2011 cuts</i>	<i>% change</i>
Agriculture, Fisheries and Food	1,296	45	3%
Communications, Energy and Natural Resources	340	8	2%
Community, Equality and Gaeltacht Affairs	338	19	6%
Defence	950	28	3%
Education and skills	8,990	170	2%
Enterprise, trade and innovation	663	14	2%
Environment, Heritage & Local Government	646	84	13%
Finance	1,275	32	3%
Foreign affairs	747	42	6%
Health and children	14,940	746	5%
Justice and law reform	2,367	74	3%
Social protection	20,828	873	4%
Taoiseach	168	8	5%
Tourism, culture and sport	346	17	5%
Transport	677	32	5%
Other	20	0	0%
Total	54,572	2,192	4%

Source: Government estimates

Social welfare cuts average 4%; unemployment rate expected to fall

In the NRP, total cuts of €2.8bn in social welfare payments were indicated over the 2011-2014 period; €873m of those were announced in the 2011 budget. A further €1.9bn in cuts will be implemented over the next three years.

The composition of the 2011 savings are highlighted in the table below.

Table 6: Composition of social welfare cuts (€m)

	<i>2011 saving</i>
People of working age	397
Child benefit	149
Rent supplement	60
State pension	0
Other	167
Reduction in the live register	100
Total savings	873

Source: Government estimates

Most of the reductions are generated from cuts in the rate of unemployment and other benefits provided to people of working age. These reductions average 4%. Child benefit is also cut, but state pensions remain unchanged.

€100m is expected to be achieved from a reduction in the live register. This is equivalent to a reduction of about 10,000 in the live register on a full-year basis, or a fall in the unemployment rate to circa 13.2%.

Public sector pay and pensions to be cut by 1.6% in 2011; pay cuts lower than highlighted in the NRP

Public sector pay and pension payments amounted to almost €18.8bn in 2010, representing almost 35% of gross current expenditure. This comprises €16bn in public sector pay and €2.8bn in pension payments.

Under the four-year plan, pay is set to be cut by €1.2bn (7.5%), largely through a reduction in staffing numbers as well as improved efficiencies under the Croke Park agreement. Public sector pensions are set to be cut by €100m over the four years.

In 2011, cuts in public sector pay and pensions combined are estimated to generate full-year savings of €309m. All of the pension cut will be introduced on January 1st 2011, resulting in a €100m saving next year. This implies savings of €209m in pay, or about 1.3% of the total 2010 bill. This is lower than the €0.4bn detailed in the four-year plan.

Public sector staff numbers are forecast to decline by just over 3% during 2011 from 309,851 at the end of 2010 to 300,308 by the end of 2011.

Health budget to be cut by 5%

The estimated budget for the Department of Health and Children for 2011 is estimated at €14.1bn, a reduction of circa 5% on the 2010 programme.

Table 7: Composition of cuts in health budget

	<i>2011 saving (€m)</i>
Demand led schemes (drug costs and professional fees)	380
Other procurement savings	200
Savings from the voluntary redundancy programme	123
Administration and other savings	43
Total savings	746

Source: Government estimates

This department buys over €5bn in goods and services, of which 40% (€2bn) is on drugs and professional fees. Cuts in this bill account for the main reduction under demand-led schemes.

Specifically, in the past week the Department has agreed with the Irish Pharmaceutical Healthcare Association (IPHA) on further price

reductions which will result in full-year savings of €200m (10% of the budget). This is in addition to €100m in savings which will be achieved in 2011 from measures introduced in 2010.

On the other €3bn of procurement costs, the Department hopes to achieve €200m in savings on a full-year basis. This is largely driven by cuts in overtime, agency and allowance payments.

Capital budget 3.6% of GDP, as outlined in NRP

Gross capital expenditure amounted to €6.4bn in 2010. In the four-year programme, the 2011 budget was cut by €1.8bn, from €6.5bn to €4.7bn.

Over the life of the programme, capital expenditure levels are set to be cut by €3bn per annum from the 2010 level. The 2011 forecast represents 3.6% of GDP. By 2014, this is forecast to decline to 2.5%. Of the 2011 budget of €4.65bn, almost one-third (€1.4bn) is transport-related of which over €1bn is on road improvement.

Important disclosures

Analyst certification

Each research analyst primarily responsible for the content of this research report certifies that: (1) the views expressed in this research report accurately reflect his or her personal views about any or all of the subject securities or issuers referred to in this report and (2) no part of his or her compensation was, is or will be, directly or indirectly related to the specific recommendations or views expressed in this report.

Investment ratings definitions

Davy ratings are indicators of the expected performance of the stock relative to its sector index (FTSE E300) over the next 12 months. At times, the performance might fall outside the general ranges stated below due to near-term events, market conditions, stock volatility or – in some cases – company-specific issues. Research reports and ratings should not be relied upon as individual investment advice. As always, an investor's decision to buy or sell a security must depend on individual circumstances, including existing holdings, time horizons and risk tolerance.

Our ratings are based on the following parameters:

Outperform: Outperforms the relevant E300 sector by 10% or more over the next 12 months.

Neutral: Performs in-line with the relevant E300 sector (+/-10%) over the next 12 months.

Underperform: Underperforms the relevant E300 sector by 10% or more over the next 12 months.

Under Review: Rating is actively under review.

Suspended: Rating is suspended until further notice.

Restricted: The rating has been removed in accordance with Davy policy and/or applicable law and regulations where Davy is engaged in an investment banking transaction and in certain other circumstances.

Distribution of ratings/investment banking relationships

Rating	Count	Percent	Investment banking services/Past 12 months	
			Count	Percent
Outperform	58	65	28	75
Neutral	24	27	9	24
Underperform	6	6	0	0
Under Review	0	0	0	0
Suspended	0	0	0	0
Restricted	0	0	0	0

This is a summary of Davy ratings for all companies under research coverage, including those companies under coverage to which Davy has provided material investment banking services in the previous 12 months. This summary is updated on a quarterly basis. The term 'material investment banking services' includes Davy acting as broker as well as the provision of corporate finance services, such as underwriting and managing or advising on a public offer.

Regulatory and other important information

Davy is regulated by the Central Bank of Ireland and is a member of the Irish Stock Exchange, the London Stock Exchange and Euronext. Davy is authorised by the Central Bank of Ireland and regulated by the Financial Services Authority for the conduct of business in the UK. No part of this document is to be reproduced without our written permission. This publication is solely for information purposes and does not constitute an offer or solicitation to buy or sell securities. This document does not constitute investment advice and has been prepared without regard to the individual financial circumstances and objectives of persons who receive it. The securities/strategy discussed in this report may not be suitable or appropriate for all investors. The value of investments can fall as well as rise and there is no guarantee that investors will receive back their capital invested. Past performance and simulated performance is not a reliable guide to future performance. Projected returns are estimates only and are not a reliable guide to the future performance of this investment. Forecasted returns depend on assumptions that involve subjective judgment and on analysis that may or may not be correct. Any information related to the tax status of the securities discussed herein is not intended to provide tax advice or to be used as tax advice. You should consult your tax adviser about the rules that apply in your individual circumstances.

This document has been prepared and issued by Davy on the basis of publicly available information, internally developed data and other sources believed to be reliable. Whilst all reasonable care has been taken in the preparation of this document, we do not guarantee the accuracy or completeness of the information contained herein. Any opinion expressed (including estimates and forecasts) may be subject to change without notice. We or any of our connected or affiliated companies or their employees may have a position in any of the securities or may have provided, within the last twelve months, significant advice or investment services in relation to any of the securities or related investments referred to in this document.

While reasonable care has been taken in the preparation of the information contained in this document, no warranty or representation, express or implied, is or will be provided by Davy or any of its shareholders, subsidiaries or affiliated entities or any person, firm or body corporate under its control or under common control or by any of their respective directors, officers, employees, agents, advisers and representatives, all of whom expressly disclaim any and all liability for the contents of, or omissions from, this document, the information or opinions on which it is based and/or whether it is a reasonable summary of the securities in this document and for any other written or oral communication transmitted or made available to the recipient or any of its officers, employees, agents or representatives.

Neither Davy nor any of its shareholders, subsidiaries, affiliated entities or any person, firm or body corporate under its control or under common control or their respective directors, officers, agents, employees, advisors, representatives or any associated entities (each an "Indemnified Party") will be responsible or liable for any costs, losses or expenses incurred by investors in connection with the information contained in this document. The investor indemnifies and holds harmless Davy and each Indemnified Party for any losses, liabilities or claims, joint or several, howsoever arising, except upon such Indemnified Party's bad faith or gross negligence.

Share ownership policy

Davy allows analysts to own shares in companies they issue recommendations on, subject to strict compliance with our internal rules governing own-account trading by staff members.

We are satisfied that our internal policy on share ownership does not compromise the objectivity of analysts in issuing recommendations.

Conflicts of interest

Our conflicts of interest management policy is available at www.davy.ie/ConflictsOfInterest.

US Securities Exchange Act, 1934

This report is only distributed in the US to major institutional investors as defined by S15a-6 of the Securities Exchange Act, 1934 as amended. By accepting this report, a US recipient warrants that it is a major institutional investor as defined and shall not distribute or provide this report or any part thereof, to any other person.

Distribution of research to clients of Davy Securities in the US

Davy Securities distributes third-party research produced by its affiliate, J & E Davy.

Davy Securities is a member of FINRA and SIPC and is regulated by the Central Bank of Ireland.

Confidentiality and copyright statement

Davy, Research Department, Davy House, 49 Dawson St., Dublin 2, Ireland. Confidential © Davy 2010.