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IRELAND: END OF THE BAILOUT PROGRAM - NOW WHAT?

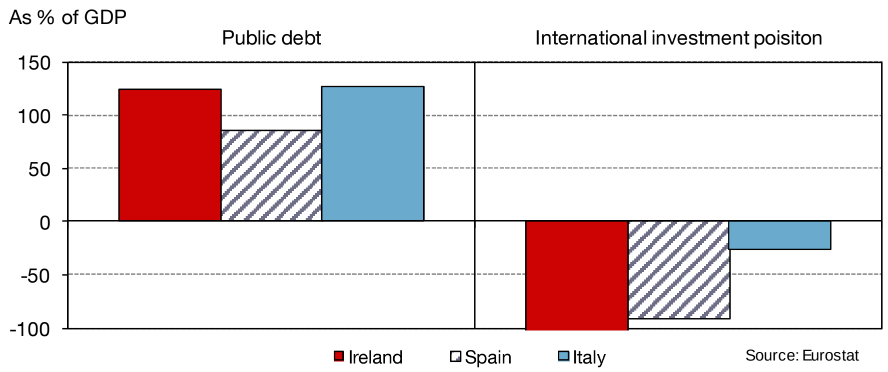
— Ireland has been hit hardly by the crisis and had to call on international aid. Indeed, not only was its economy highly dependent on external financing, but more importantly, the country had experienced a real estate bubble burst, leading to the virtual collapse of its banking system. And with an oversized banking system, the country found itself on the edge of a cliff.

— The international bailout program, which ended last December, is considered as a success. Ireland should be the first eurozone country under an aid plan to come out on top: the real estate bubble has been deflated, the banking system has been restructured, activity has stabilised, and the sovereign has successfully access to debt markets.

— Nonetheless, the country combines some of Spain's and Italy's difficulties. As a result, significant adjustments still await. Activity is still well below its pre-crisis level, public finances show high debt and deficit levels, the country's net international investment position is still very deteriorated, and households are still struggling with high debt, which they are having more and more trouble repaying.

— All told, the country has pulled ahead of the group of countries under program (Greece, Portugal), but it is still far away from the core countries of the euro zone: it now ranks among the countries in an intermediate situation, together with Spain and Italy.

HOUSEHOLD DEBT AND INTERNATIONAL INVESTMENT POSITION



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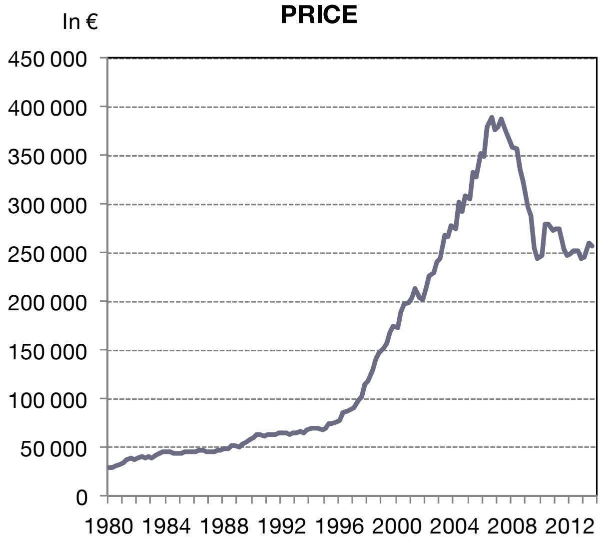
THE CRISIS HIT IRELAND ESPECIALLY HARD

A HUGE REAL ESTATE BUBBLE...

Before the crisis, Ireland had a huge real estate bubble characterised by soaring prices and a bloated construction sector. On average, existing home prices rose more than 15% per year between early 1996 and early 2007 (see graph 1), and the construction sector's weight in the economy went from 6.1% of GDP in 1996 to 11.1% of GDP in 2006, contrasted with a weight of 7% of GDP for the eurozone as a whole.

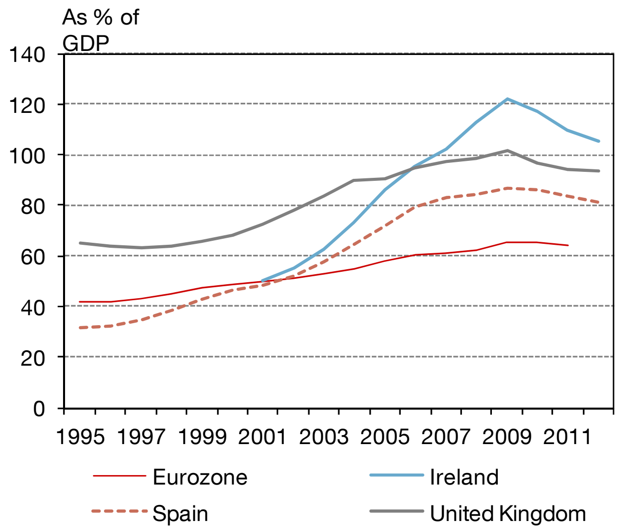
GRAPH. 1: SECOND HAND HOUSES PRICE



Source: datastream

This real estate frenzy was accompanied – indeed made possible – by a rapid rise in households' indebtedness.

GRAPH. 2: HOUSEHOLDS DEBT RATIO



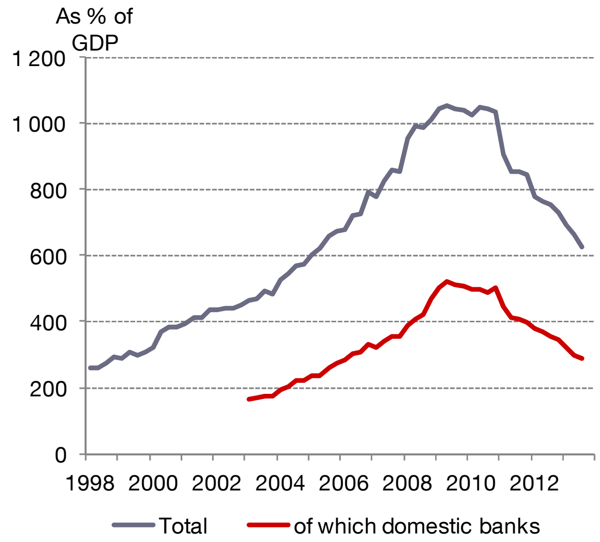
Source: eurostat

In 2001, the debt ratio of Irish households was 48% of GDP, around the eurozone average. It then rose sharply to reach 120% of GDP in 2009, significantly more than the rest of the eurozone (see graph 2). And it was even higher than in the UK or Spain, both of which have had a real estate bubble. An aggravating factor is that the financial assets of Ireland's consumers facing this massive indebtedness were limited. Their financial assets minus their debts expressed as a percentage of GDP was the lowest in the European Union 15.

... PAIRED WITH AN OVERSIZED BANKING SYSTEM...

At the same time, the pre-crisis period in Ireland was marked by the lightning-fast growth of the banking sector. In 10 years, its balance sheet grew from a little more than two and a half times GDP to more than 10 times GDP (see graph 3).

GRAPH. 3: BANKING SECTOR SIZE



Source: Central Bank of Ireland

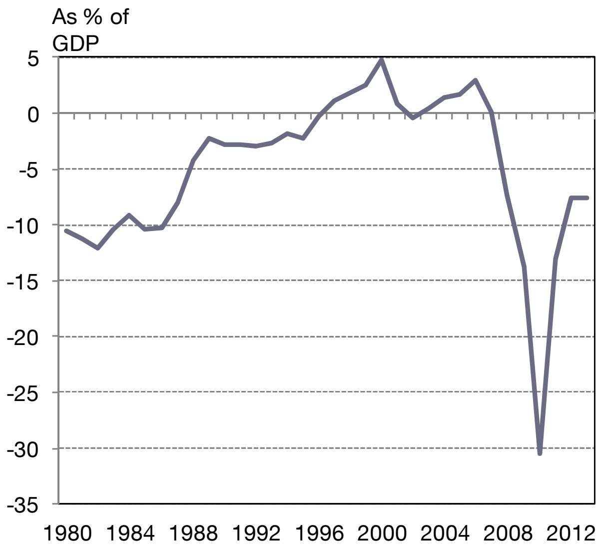
Still, the size of the banking system should be put into perspective somewhat, as the numbers have been distorted by the IFSC (International Financial Services Centre, see box). Indeed, if we look only at banks operating on the Irish domestic market, their weight was half that. But even corrected this way, it is still large, and has risen sharply in just a few years (see graph 3).

.... BROUGHT PUBLIC FINANCES TO THE BRINK OF DISASTER.

When the real estate bubble burst, and caused such losses, all of Ireland's banks nearly got bankrupted, which forced the State to nationalise them. Because of the size of both the real estate bubble and the banking system, the cost of that bailout was very high: the IMF estimates it at 40% of GDP. As a result, public deficit was nearly 15% of GDP in 2009, then more than 30%

of GDP in 2010 (see graph 4), and the country was forced to apply for an international bailout program.

GRAPH. 4: PUBLIC SECTOR BALANCE



Source: Eurostat

COMPETITIVENESS AND CURRENT ACCOUNT BALANCE BOTH DETERIORATED

At the same time, the country's external accounts worsened. The country's current account balance went from virtual equilibrium in 2000 to a deficit of more than 5% of GDP in 2007 and 2008. This decline was essentially the result of an eroded trade balance. Specifically, beyond the fact that activity in Ireland was more buoyant than in its primary partners over that period, Ireland's competitiveness within the eurozone fell off significantly. Unit labour costs rose 42% between 2000 and 2008, vs. 15% on average for the eurozone as a whole, though with significant disparities within (+0% for Germany and +31% for Spain).

AND ACTIVITY PLUMMETED.

With the brunt of the international crisis and the bursting of the housing bubble, Irish activity plummeted: between end-2007 and end-2009, it contracted by 11.5%. This decline was primarily a result of the collapse of investment (-40%), and specifically construction, which plunged, to be reduced to less than 3% of GDP in 2009.

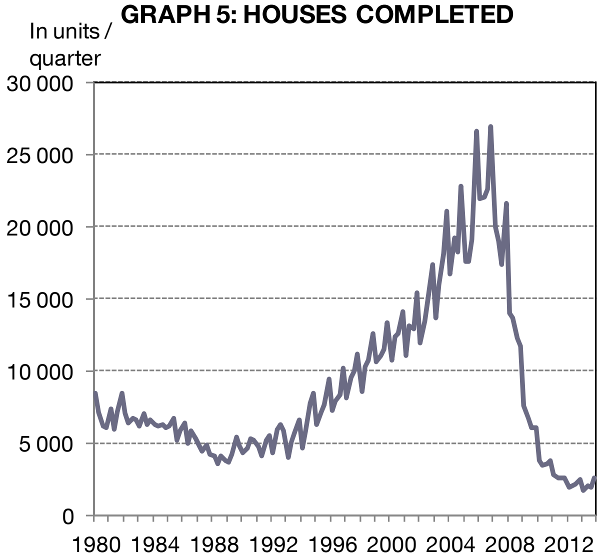
However, this drop-off in activity should be viewed in light of the boom that the Irish economy had enjoyed in the years leading up to it. Overall, for the 2000s, Ireland posted average annual growth of 2.3%.

SUBSTANTIAL ADJUSTMENTS WERE MADE

HOUSING BUBBLE DEFLATED

The Irish real estate bubble deflated spectacularly, as already shown by the shrinking weight of construction in the economy. Thus, fewer homes are built in a year now than were built in a month at end-2006 (see graph 5). At the same time, housing prices have been virtually cut in half compared to their mid-2007 peaks. And consumer debt has begun to fall, though as yet only in limited fashion.

GRAPH 5: HOUSES COMPLETED



Source : Central Statistics Office

BANKING SYSTEM INTO RESTRUCTURING

To return the banking system to health, the government quickly took significant measures that profoundly changed the country's banking landscape.

Thus, beginning in April 2009, it transferred the banks' bad mortgages to a defeasance structure, the National Asset Management Agency. NAMA reshaped the banking sector using the country's major banks, which were nationalised and recapitalised, based on three pillars: the first was the Bank of Ireland (not to be confused with the Central Bank of Ireland); the second was called the Irish Bank Resolution Company (IBRC), created by the merger of Allied Irish Bank and EBS Building Society; the third was Irish Life and Permanent (ILP), which had previously recovered a portion of the Irish Nationwide Building Society. IBRC's bankruptcy in 2013 reduced the number of pillars to two. Finally, this redesigned banking sector went on a diet. The government refocused the banks on their core business by selling off foreign and non-banking subsidiaries.

In all, the number of major banking players on the Irish domestic market was sharply reduced, and the size of the domestic banks was cut by more than one-third in just four years.

AUSTERITY/COMPETITIVENESS POLICY

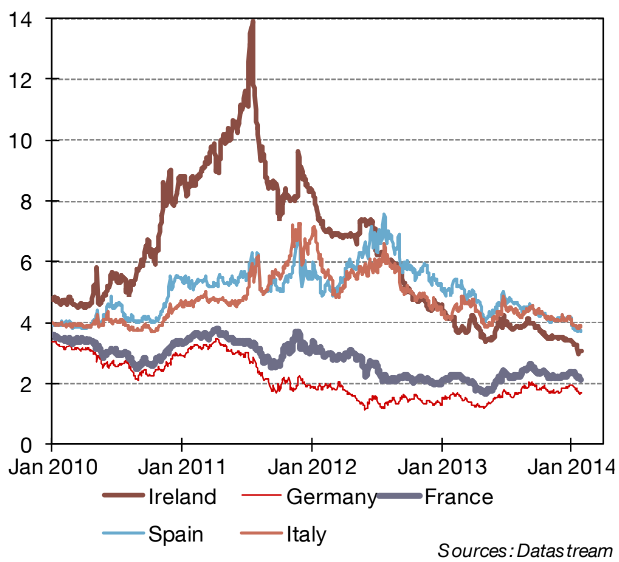
At the same time, the government took austerity measures to recover the country's public finances. One-third of these measures, which represent about 8% of GDP according to the IMF, were tax increases, and two-thirds were spending cuts, with significant cuts to public-sector wages (-14%) and workforce (10%), and a decline in social services.

Moreover, to support the Irish economy's competitiveness and growth potential, structural reforms were also put in place, heightening competition and making the labour market more flexible. As a consequence of these measures, but also of the severity of the crisis, Irish unit labour costs fell back significantly, by nearly 15% compared to end-2008, whereas they continued to rise in the eurozone as a whole, and had jumped before the crisis (+51% between early 2000 and end-2008, vs. +18% on average for the eurozone). Consequently, they are now back at their 2006 levels.

BAILOUT PROGRAM CONSIDERED AS A SUCCESS

In all, the Irish bailout program, which ended in December 2013, is considered as a success: the banking sector has been largely restructured as announced, the country has emerged from recession, public debt is expected to decrease starting in 2014, the country has had several successful debt issues in 2013 at reasonable costs and, on the markets, interest rates on Irish public debt are lower than Spain's and Italy's (see graph 6).

GRAPH. 6: SOVEREIGN DEBT, 10-YEAR INTEREST RATE



Sources: Datastream

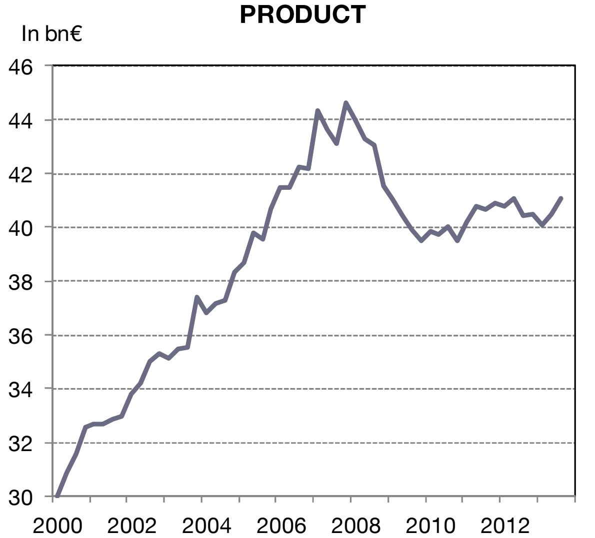
Against this backdrop, contrary to what may have been expected until recently, the government has decided not to request a precautionary line from its partners to secure its financing in the period after the program ends.

YET IRELAND REMAINS A COUNTRY ON THE PERIPHERY, LIKE SPAIN AND ITALY.

STRUGGLING TO RESTART ECONOMIC GROWTH

In terms of economic growth, this optimism should nonetheless be tempered. Indeed, though the country is no longer in a recession, the recovery of activity is still laborious, with activity alternating positive and negative growth rates in the last two years. Above all, in Q3-13, Irish GDP was still 8% below its pre-crisis level, and it is only slightly higher than its lowest point at the height of the crisis (see graph 7).

GRAPH. 7: REAL GROSS DOMESTIC PRODUCT



Source: CSO

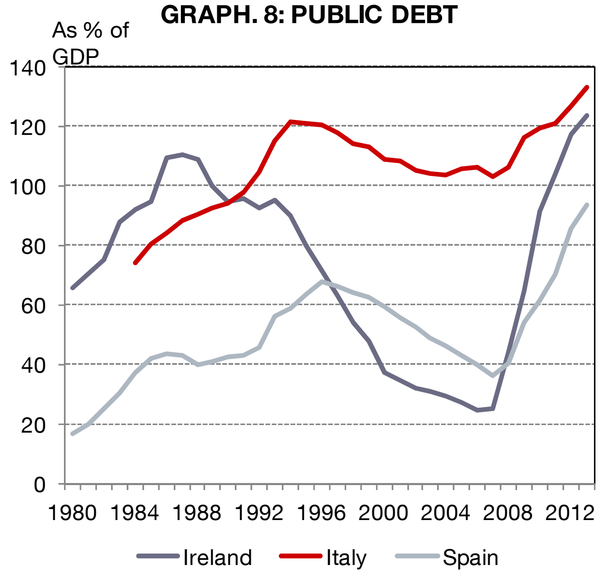
PUBLIC FINANCES STILL REQUIRE ADJUSTMENTS

Irish public finances no longer show the extreme imbalances they did at the peak of the crisis, with a deficit that culminated at more than 30% of GDP in 2010. Yet their consolidation is far from complete. As such, for 2013 the European Commission predicts a public deficit still at nearly 7.5% of GDP and public debt of 124% of GDP, i.e. a combination of the fourth highest debt in the eurozone (after Greece, Italy and Portugal) and the third highest deficit (after only Greece and Cyprus).

Consequently, major adjustments are still needed to truly restore the public finance situation (see graph 8). They are not out of reach. Indeed, Ireland has made adjustments of this scale in the past. In the early 1980s, the country accumulated deficits to the point where, in

1987, it had a deficit of 8% of GDP and public debt of more than 110% of GDP. And twenty years later, debt had been brought down to less than 25% of GDP.

GRAPH. 8: PUBLIC DEBT



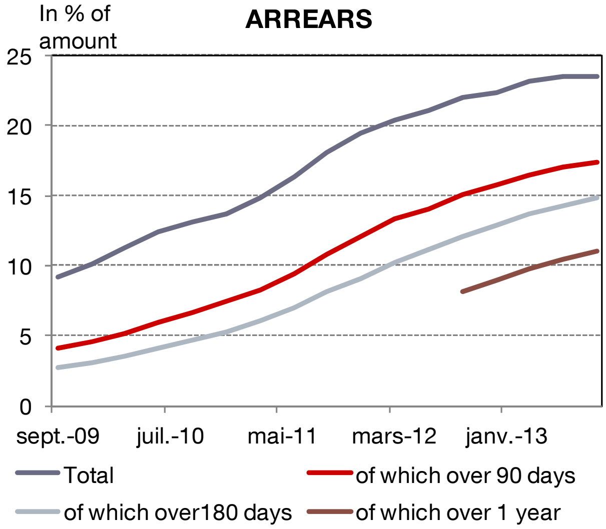
Source: Eurostat

Nonetheless, the context in which this first adjustment was made was very different from today's. In the current crisis, most developed countries have to make deleveraging efforts – public and sometimes private, simultaneously – which is a significant impediment to global activity. Most importantly, in the early 1980s, Ireland was one of the poorest countries in Western Europe: its per capita income[1] was one-third less than Germany's or France's and 10% lower than Spain's. The country did catch up (supported by the government-led policies) to the rest of the European Union, which helped this adjustment. This catch-up phase was one of sustained and lasting growth as well as high inflation. All these factors supported public revenues, reduced spending requirements and mechanically lowered the public debt compared to nominal GDP. Such a trajectory seems hard to reproduce now, if only because Ireland is now one of the eurozone's wealthiest countries, with per capita income that is 20% above the eurozone "12" average (11 original members plus Greece), and even 6% higher than Germany's.

HOUSEHOLDS' FINANCIAL SITUATION IS STILL VERY POOR.

Households' financial situation is still also very poor. First, although households debt has begun to fall, from more than 120% of GDP in 2009 to 105% of GDP in 2012, it is still very high: much higher than the average for eurozone households and even higher than that of Spanish households at the peak of the crisis. Second, the financial situation of indebted Irish households appears extremely precarious: nearly one-quarter of outstanding home loans to consumers for the purchase of a primary home are in arrears, and 11% of those loans are in arrears over one year (see graph 9). The situation of loans made for rental investments is even more critical, with more than one-third of outstanding loans are in arrears.

GRAPH. 9: MORTGAGES FOR PRINCIPAL DWELLING HOUSE IN ARREARS



Source: Central Bank of Ireland

In all, this represents more than EUR36bn (22% of GDP) in outstanding consumer housing loans that are behind on payments, of which EUR18bn that are behind by more than a year. Furthermore, this proportion continues to rise, and we see a slide toward long-standing arrears (the proportion of loans showing arrears of less than three months remains around 6% of outstanding loans).

Thus Irish households seem to be faced with very high debt ratios, with which they are less and less able to cope.

THE ADJUSTMENT OF EXTERNAL ACCOUNTS IS STILL ONLY PARTIAL

As regards the adjustment of external accounts, there is still a way to go. After the chronic current-account deficits of the previous decade (-5.6% of GDP in 2007), the country has just returned to current surpluses (+4.4% of GDP in 2012). This adjustment was made possible by renewed competitiveness, which buoyed exports, but especially by the deep slump in domestic demand, which sent imports downward. Yet its net external position[2] is still negative, with a deficit of more

[1] *Measured in terms of GDP per capita in purchasing power parity.*

[2] *Or the difference in outstanding between Irish residents' investments abroad and foreigners' investments in Ireland.*

than 110% of GDP in 2012 (overall and non-IFSC), a position that is still more in debt that Spain's.

Significant current-account surpluses over the long term would be required to absorb such an imbalance. Indeed, this imbalance makes the country dependent on foreign capital and, consequently, vulnerable to a reversal in investor sentiment toward it, since it relates almost entirely to net external debt (at 90% of GDP excl. IFSC, a level comparable to Spain's).

THE IRISH ECONOMIC SITUATION IS BORROWING SOME SIMILARITIES FROM BOTH ITALY AND SPAIN

In all, though Ireland should be able to come out with its head held high from the international bailout program it had to resort to, its situation is still difficult, and it is combining handicaps of both Spain (for the scope of the deficit, the financial situation of households that still weighs on risks to the banking system, and the deteriorated net international investment position) and Italy (for the high public debt level). Broadly speaking, we could say Ireland has pulled ahead of Greece and Portugal and is closing in on Spain and Italy, but that it is still quite a way from the eurozone's core.

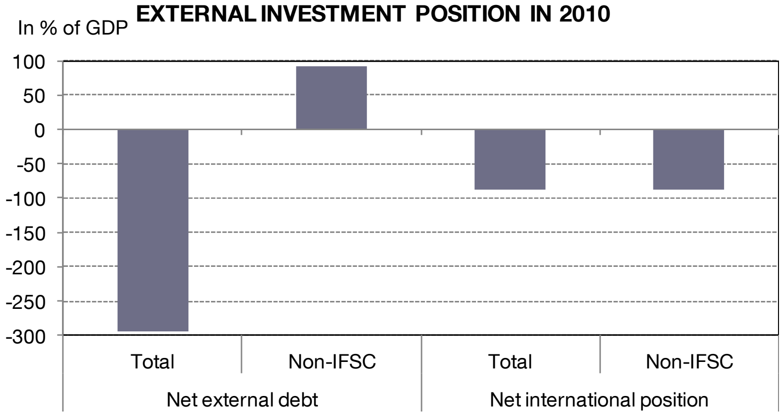
BOX 1 - INTERNATIONAL FINANCIAL SERVICES CENTRE: A COLOSSUS THAT COMPLICATED THE DIAGNOSIS.

The International Financial Services Centre was created in Dublin in 1987 to promote the establishment of international financial services in the country. To do this, the centre was given a highly advantageous exceptional tax status, which drove many international financial institutions to place their businesses there.

This centre quickly grew, with the balance sheets of financial institutions hosted there reaching nearly six times Irish GDP in 2008, substantially more than the entire Irish banking system focused on the national market.

This colossus may have distorted the assessment of Ireland's situation – first, by skewing the size of the Irish banking system: according to the usual measurement, it was 10 times the size of the national GDP, but more than half of that was for operations without any real link to the national economy, where assets and liabilities in fact belonged to operations abroad and carried no guarantee – express or implied – from the Irish government; and second, by making major changes to the equilibrium of the country's balance of payments. Thus in 2010, the country had negative net foreign debt at nearly 300% of GDP. In other words, the country held more receivables on foreign countries than foreign countries held on it, equal to nearly three times its GDP, which is usually a strong factor of resilience to international financial turbulence. However, in Ireland's case, this number actually masked a major weakness: not including the IFSC, Ireland had net foreign debt of nearly 100% of GDP, which put it at the mercy of a reversal in international financing. Still, statistics on the country's net foreign position should have drawn attention to this weakness, which was extremely serious, at close to -100% of GDP.

EXTERNAL INVESTMENT POSITION IN 2010



Source: CSO

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