

DBRS Canada Newsletter

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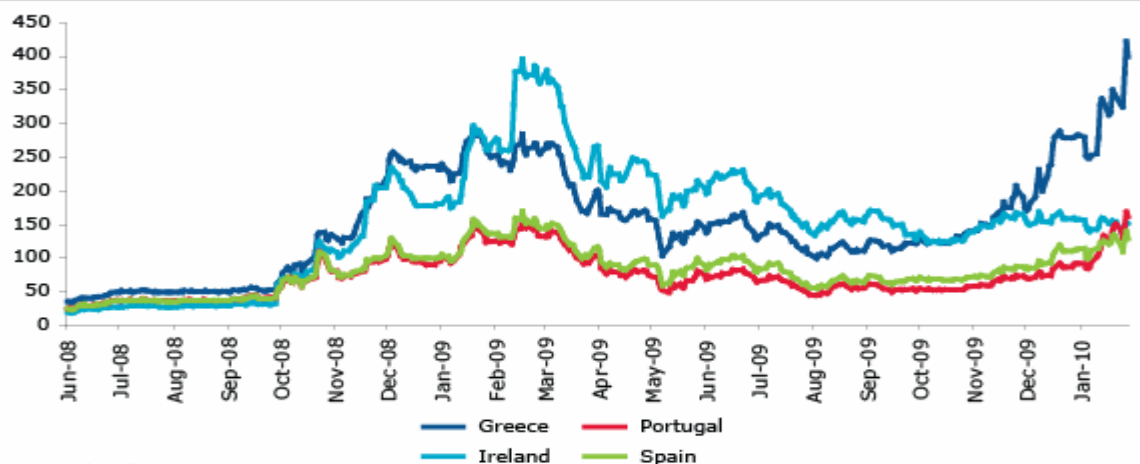
FISCAL CONSOLIDATION SUPPORTS IRELAND'S STABILIZATION AND MEDIUM-TERM RECOVERY

The global economic and financial crisis has arguably hit Ireland's public finances harder than any other country in the eurozone. The deterioration was primarily caused by an over-reliance on revenues derived from asset price transactions, a surge in spending in the years preceding the crisis, a sharp contraction in economic activity and an undercapitalized banking sector exposed to a bursting property bubble. From 2007 to 2009, the budget shifted from a surplus of 0.3% of GDP to a deficit of 11.7% of GDP, the public debt burden rose from 25% of GDP to an estimated 65% of GDP and a blanket guarantee of bank debt and deposits increased the government's contingent liabilities to over two times GDP.¹ To complicate matters, Ireland faces significant downside risks this year, including weak demand from its main trading partners, uncertainty regarding the size of its bank recapitalization needs and market concerns about the solvency of several countries in the eurozone.

Nevertheless, Ireland's policy response has been strong, transparent and well-designed, and serves as an example for other countries in the eurozone facing budget deficits and rising debt burdens. In addition to repairing the banking sector, the government's fiscal consolidation plan is comprised of structural reforms that could restore budgetary stability and lay the foundation for a more resilient and competitive economy.

While fiscal consolidation will have a net contractionary effect on economic activity in the short term, large and clearly identified deficit-reduction measures have restored a degree of confidence in Ireland's public finances. From March 2009 to January 2010, ten-year sovereign spreads over German bunds narrowed 150 basis points. Moreover, Ireland five-year credit default swap (CDS) spreads have diverged from Greece and are approaching Portugal and Spain, reflecting country differentiation among investors.

Five Year CDS Spreads

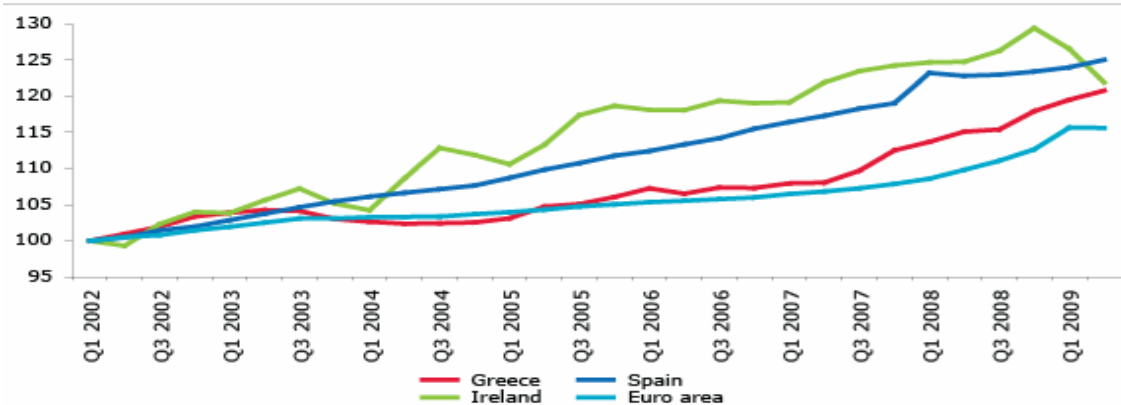


Source: Bloomberg, DBRS.

Improved market perception of Ireland's fiscal sustainability is partly due to the severity of the consolidation measures. Tax increases and spending cuts last year totaled EUR8 billion (4.9% of GDP). This year's budget calls for another EUR4 billion (2.5% of GDP) adjustment. Greater market confidence is also a response to the government's resolve and transparency. Against strong political headwinds, the government took decisive action to stem fiscal deterioration and spelled out a clear and realistic plan to reduce the deficit below 3% of GDP by 2014. As a result, Ireland's National Treasury was able to issue EUR34 billion in medium- and long-dated bonds in 2009, as well as EUR6.5 billion in the first three weeks of 2010, covering one-third of this year's overall funding needs, at significantly lower borrowing costs.

Over the medium term, the structural nature of the fiscal adjustment could prove even more important than the size. The onus of consolidation in 2010 is on permanent current expenditure cuts, particularly public sector wages and social welfare benefits, rather than tax increases or reductions in public investment. The advantage of this expenditure-reduction strategy is that it lowers the structural deficit while improving medium-term growth prospects. Salary and benefit reductions for over 300,000 public workers will help induce economy-wide nominal wage deflation and restore international cost competitiveness. Unit labor costs in Ireland, unlike Greece and Spain, have already started to adjust. As a result, the export sector is likely to be in a better position to contribute to the recovery. Furthermore, the government's pledge to keep the corporate tax rate at 12.5%, less than half the eurozone average of 25.9%, should attract investment and support growth.

Unit Labor Costs



Source: OECD, DBRS
Note: Q1 2002 = 100, seasonally adjusted

In December 2009, the Minister of Finance proposed additional structural reforms to address the inadequacies of the tax system and reduce public liabilities associated with an ageing population. The proposed tax reform would widen the tax base and reduce revenue dependence on property sales, while an entitlement reform would trim liabilities from the public pension system. These proposals provide further evidence of the government's commitment to economic stabilization and long-term sustainability of its public finances.

While each country faces a unique economic situation, it would behoove other fiscally challenged eurozone countries to note several important aspects of Ireland's policy response. First, Ireland spelled out a realistic and transparent multi-year deficit reduction plan to restore market confidence and reduce borrowing costs. Second, the fiscal adjustment largely depends on permanent cuts in current expenditure, particularly wages and transfers. Third, structural reforms are being proposed to restore competitiveness, improve the resiliency of public finances and reduce long-term liabilities. While the political environment will dictate the capacity of other governments to take corrective measures, the unwillingness to make difficult decisions today could lead to more painful adjustments in the future.

Eurozone countries such as Ireland do not have access to an independent monetary policy or a flexible exchange rate to jump-start economic growth. Yet Ireland is illustrating how fiscal adjustment focused on structural reforms can restore sustainability to public finances and help the economy regain competitiveness. While the government still needs to follow through on its commitments and overcome significant downside risks in the coming years, the policy response to the crisis so far has put the country on a path to sustainable recovery.

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1. Public debt and contingent liability figures do not include projected liabilities of the National Asset Management Agency (NAMA). DBRS estimates that NAMA liabilities will total 33% of GDP in 2010.