



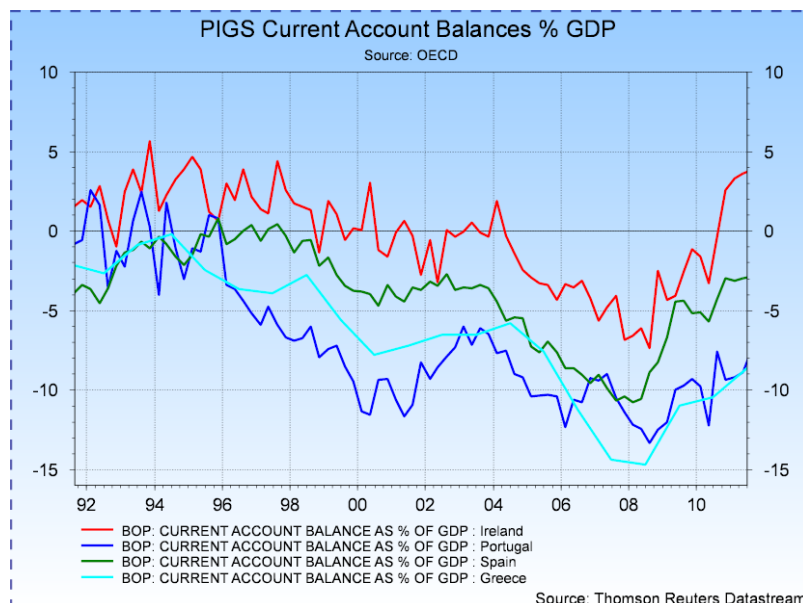
## Irish plan for emerald-green shoots

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The current situation in Ireland is just one aspect of a much larger Euro sovereign debt problem. However, as the anniversary of the Irish bailout approaches in the autumn, it is worth reviewing what progress has been made in the interim.

Ireland has a plan: to recreate the same export-led recovery which drove economic growth in the 1990s. Without its own currency, the country has undertaken a painful internal devaluation, through falling wages and prices, in order to restore competitiveness. When combined with a low tax regime and a young flexible, educated workforce, the hope is that this will act as a powerful initial catalyst for growth. In stage two, export-led growth is then expected to feed into rising investment and employment, which in turn will fuel consumption and a more balanced recovery. Improving growth will create a virtuous circle in public finances and as these improve, the cost of government debt will fall and create another virtuous circle: lower cost of debt means stronger public finances. That's the theory, what about the practice?

Initial signs are encouraging. Ireland remains one of the most open economies in the world, with exports accounting for more than 100% of GDP, compared with an EU average of c.40%. At the risk of sounding like one of those adverts, the country does continue to attract inward investment, with many multinationals choosing Ireland as their European hub. Of the four small PIGS, Ireland is the only one which has moved into a current account surplus (see chart), so the country is no longer accumulating external liabilities and is "paying its way". Across the modern and traditional sectors, key export industries include pharmaceuticals, chemicals, software and food. The presence of these multinationals means that defence of their low tax status within Europe remains a key part of Ireland's recovery plan, something which no doubt the Irish will have stressed to their European partners.



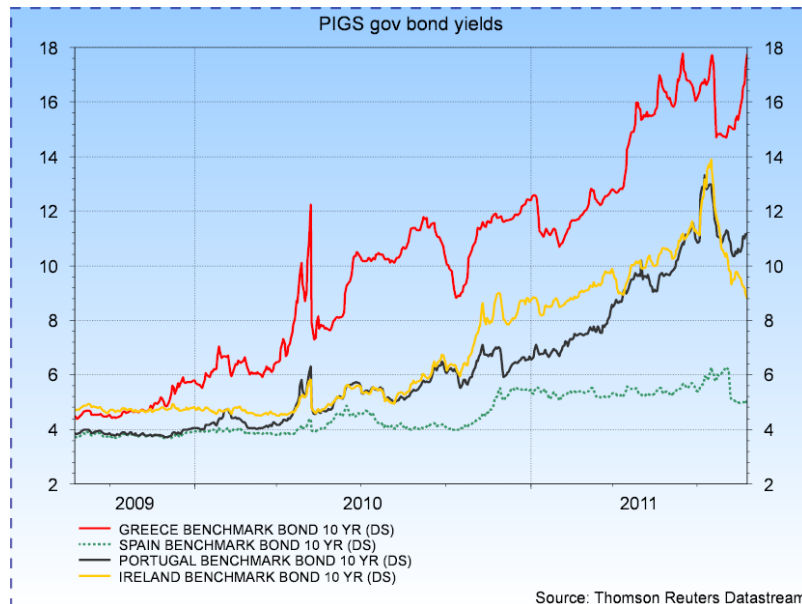
In contrast to the more buoyant trade picture, the domestic sector remains subdued, with households under pressure from deleveraging and fiscal austerity, investment hampered by the collapse of the property sector, and a government seeking to reduce its share of the economy. Structural reforms to boost growth potential include privatisations and welfare reform and in the near term, some of these reforms put further pressure on domestic

demand via a higher savings rate. So a key part of the recovery strategy will be to stabilise the domestic sector at current levels and prevent a further bout of weakness. Perhaps the greatest contrast with the other PIGS, apart from the current account position, is relative political stability and a general acceptance that the economy needs to be restructured. Approval ratings for the new administration are high and this should buy them some time while they introduce difficult reforms.

The fiscal situation looks dire, given the collapse in tax revenues and rapid rise in government debt. Yet there are signs of improvement here, helped by a wider personal tax base and some pick up in corporate tax take. Greater detail on spending cuts is due to be announced in the autumn, however, to date there have been some large adjustments, including cutting public sector pay and welfare payments. The aim is to reduce the deficit below 3% of GDP by end 2015 and be in primary surplus by 2014, in order to stabilise growth in the stock of public debt.

So what could derail the strategy? The plan relies on reasonably robust growth rates of 2.5-3% over next few years and these may not materialise, either because global growth is too weak to benefit trade or the domestic sector goes into a second retreat. Growth in the 1990s came during a period of sustained global expansion, which Ireland was well placed to take advantage of. The UK & the Eurozone remain key export markets and the economic outlook for these economies is hardly stellar. Ireland also needs to disentangle its banks from the sovereign balance sheet and put them back on a normal footing, with access to market funding. This may be difficult to achieve. On top of all this, it is hard to undertake fiscal consolidation without a little bit of extra help from inflation.

The European debt crisis itself has moved rapidly from the specific to the general. It is no longer just a question of solvency for one or more of the peripherals, rather it is about the survival of the Euro project itself. Europe has to prevent a liquidity problem for Spain and Italy becoming a solvency issue, since in that event, neither the German or French government balance sheets would be large enough to take on the burden. The ECB can keep its finger in the dyke for now, although a more sustainable solution requires a sharing of balance sheet strength across the Eurozone. Understandably Mrs Merkel wants a rigorous fiscal discipline structure in place before agreeing to Eurobonds, yet there may not be enough time and anyway this puts cart before horse: if there was rigorous fiscal discipline at country level you wouldn't need Eurobonds in the first place. Germany is caught between the Scylla of underwriting its more profligate neighbours and the Charybdis of Euro break up. Ireland will continue with its own recovery plan, but to a large extent, success or otherwise lies outside its control.



Source: rlam as at 26 August 2011 unless otherwise stated.

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