Creditreform Sovereign Rating

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Rating Object	Rating Information	
REPUBLIC OF IRELAND	Assigned Ratings/Outlook: **A /positive**	Type: Follow-up Rating, unsolicited
Long-term sovereign rating Foreign currency senior unsecured long-term debt Local currency senior unsecured long-term debt	Initial Rating Publication Date: Rating Renewal: Rating Methodologies:	25-11-2016 24-11-2017 "Sovereign Ratings"

Rating Action

Neuss, 24 November 2017

Creditreform Rating has revised its outlook on the Republic of Ireland to positive from stable and affirmed the unsolicited long-term sovereign rating of "A". Creditreform Rating has also affirmed Ireland's unsolicited ratings for foreign and local currency senior unsecured long-term debt of "A".

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Key Rating Drivers

1. Strong macroeconomic performance; Irish GDP growth outpaced most EA-19 peers in 2016, though headline indicators remain difficult to interpret; going forward, considerable macro-financial risks resulting from Brexit-related uncertainty
2. Due to high quality of institutional conditions, sound regulatory framework, and low taxes, Ireland remains one of the most business-friendly countries in Europe
3. Public debt is still elevated but should continue to decline on the back of robust growth and primary surpluses in 2017-18; potential risks arising from financial sector legacies seem broadly contained in view of improving bank balance sheets
4. Fiscal consolidation progressed in 2016 and is set to continue in the medium term; however, revenues remain vulnerable in the event of an economic downturn or significant changes in international taxation
5. Risks associated with a volatile current account and highly negative NIIP are somewhat mitigated by ongoing external deleveraging and a favorable composition of external debt

Reasons for the Rating Decision

Creditreform Rating has revised its outlook on the Republic of Ireland to positive from stable. The positive outlook is underpinned by our expectation that (i) key macroeconomic indicators, which point to an improvement in economic conditions, will maintain their momentum; (ii) the headline budget deficit continues to narrow, while private and public debt remain on a downward trajectory; and (iii) monetary transmission should benefit from gradually improving asset quality in the domestic banking sector.

The very high quality of Ireland's institutional setting remains a key support to the sovereign's credit rating. Assessing the World Bank's World Governance Indicators (WGIs), Ireland outperforms not only its A-rated peers, but also most EA-19 members. The sovereign is characterized by an effective policy formulation and implementation (WGI rank 25) and achieves very high scores with regard to the soundness of business regulation and democratic participation – ranking 12th and 14th on the World Bank indicators "Regulatory Quality" and "Voice & Accountability". This compares favorably with EA-19 median ranks of 33 and 29 respectively. Ireland's strong institutional framework is also conducive to its business environment, strengthening the competitiveness of the country's private corporate sector. The 2018 Doing Business report, ranking Ireland 17th out of 190 economies (11/32 OECD high-income), confirms this view. Above all, the Irish tax system remains a key competitive advantage. While Ireland's total tax and contribution rate on corporate profits posts at a low 26%, dealing with taxes consumes only 82 hours per year. This compares well to an average of 160.7 hours and a total rate of 40.1% in OECD high-income countries. The favorable business environment is also reflected by Ireland's performance in the EU 2016 SME performance review. As regards entrepreneurship, innovation and the responsiveness of the administration, Ireland outperforms the EU-28 average by far.

Our assessment of Ireland's macroeconomic performance incorporates high per capita income levels and the economy's strong recovery in 2015-16. That said, multinational enterprise (MNE) relocations, the onshoring of intellectual property (IP) and aircraft leasing operations lead to significant distortions in the Irish national accounts, making it difficult to assess the underlying economic activity. However, alternatives measures such as clean GNI and modified domestic demand, which are accounting for the highly globalized nature of Ireland's economy, also point to robust growth of the domestic economy. In our view, medium- term growth prospects appear favorable despite some downside risks pertaining to a "hard Brexit" or significant changes in global taxation standards.

The Irish economy continues to be characterized by a high degree of openness as well as by high levels of productivity. While the trade-to-GDP ratio stood at 221.2% in 2016, Irish GDP per capita of USD 62,276 (in PPP terms) was the second highest in the euro area. Also, Ireland outperformed most of its EA-19 peers when it came to GDP growth. In real terms, Irish GDP expanded by 5.1%, entirely driven by strong domestic demand. Investment contributed the bulk to the increase in economic output. After growing by 27.9% in 2015, gross fixed capital formation (GFCF) surged by another 61.2%, mainly due to business activities of multi-national enterprises (MNEs), namely aircraft leasing and the transfer of intellectual property to Ireland. As a result, investment in transport equipment grew by 52.7%, while investment in R&D, which includes patent on-shoring, more than doubled (+121.9%) from 2015 levels. Together, these items explain about 90% of the 2016 increase in headline investment. Adjusting for these distortions, gross fixed capital formation was still up 11.0% y-o-y, with construction being the main driver. On the back of brisk demand for housing, construction investment saw the strongest increase (+18.7%) since 1996. Output growth was also fueled by consumption, which contributed 1.2 p.p. to total output expansion. Both public and private consumption expenditures continued to

grow at solid rates. In the absence of inflation, household spending (+3.2%) benefited from higher levels of employment. The strongest employment growth in ten years (2016: +2.8%) helped to bring down the unemployment rate from 9.4 to 7.9% in 2016. By contrast, net exports detracted from GDP growth. Mirroring last year's investment performance, import figures (+14.4%) were inflated by sizeable transfers of intangible assets. At the same time, exports expanded only by a modest 2.7%, in particular due to weak contract manufacturing abroad by Irish-based MNEs. Moreover, the appreciation of the euro-sterling exchange rate had a dampening effect on exports. While merchandise exports to the EU (excl. UK) and to North America rose by 1.6 and 18.3% respectively, the value of exports to the UK fell by 3.3%.

As regards 2017, we expect total output to grow by 4.7%. While y-o-y growth fell from 6.3% in Q1-17 to -1.3% in Q2-17, alternative metrics recently introduced by the Central Statistical Office point to a still robust growth performance of the Irish economy in the first half of 2017. Modified domestic demand, which excludes the volatile components of investment in intangibles and aircraft leasing, grew at rates of 6.1 and 4.2% in Q1 and Q2 respectively. In particular, the recovery of the housing market continues to boost construction investment. In the first six months of 2017, GFCF in construction stood 20.1% above the previous year's levels. Thus, underlying investment activity should remain robust, while headline investment is set to contract significantly due to base effects related to asset-onshoring. Meanwhile, private consumption should hold up well, given our expectation of rising disposable household income in 2017. Further improvements in the labor market as well as subdued inflation prospects should support private consumption going forward. As of now, we anticipate HICP inflation to turn the corner in 2017 and post at a moderate 0.3% (2016: -0.3%). Notwithstanding that domestic demand remains the main driver of output expansion, stronger net exports should also be conducive to GDP growth. Assuming a sharp decline in intellectual property imports and somewhat higher external demand on the back of improving growth perspectives in key export markets, net exports should make a small but positive contribution to growth. Looking ahead to 2018, growth should converge towards the economy's potential growth rate and edge down to 3.8%, as we expect construction activity to lose some steam while investment in intangible assets should continue to normalize. At the same time, private consumption is expected to remain the main driver of economic expansion, driven by growing employment and gains in disposable household incomes. To be sure, external downside risks to our 2018 growth forecast are substantial against the backdrop of uncertainties related to the ongoing Brexit negotiations. Given that the UK is the second largest single-country export destination for Ireland's goods and the largest for its services, the trade channel is likely to be negatively affected by a hard Brexit. According to estimates by various domestic forecasters, a 1% drop in the UK's GDP may lower Irish GDP by between 0.3 and 0.8%, depending on the time horizon.

With regard to fiscal sustainability, our assessment balances still high debt levels and a volatile revenue composition against receding banking sector risks and further improvements in the government's budgetary position.

After the headline deficit amounted to 1.9% of GDP in 2015, it narrowed to 0.7% of GDP last year. However, one-off revenues from repaid EFSF margins and a base effect from the Allied Irish Bank (AIB) capital transfer explain about 0.5 p.p. of last year's change in the general government's deficit. The budget improvement was also driven by the favorable economic development in 2016, which translated into brisk revenue growth. Taxes and social contributions increased by 4.2 and 5.8% respectively. According to Ministry of Finance data, both CIT- and PIT-receipts surprised on the upside. Strong tax receipts more than compensated for a decline in non-tax revenue, resulting from lower bank guarantee fees and dividends from state-owned enterprises. In contrast with 2015, the expenditure side also contributed to budget consolidation. Significantly higher government investment (+12.8%) was more than offset by a further decrease in interest expenditure. More importantly, spending on social benefits and employee compensation, which are the largest expenditure items in the state budget, lagged behind GDP growth and thereby also had a positive effect on the budget balance.

Turning to the current year, the government provided households with some tax relief. The tax package included in the budget 2017 focuses on reducing the tax burden for low to middle income earners. Alongside reductions in the Universal Social Charge, the earned income credit and the home carer credit were increased. In addition, a new tax rebate was introduced to support first time buyers of new houses (help-to-buy scheme). At the same time, the government envisages higher spending on social benefits, investment and public employees. Regarding the latter, additional costs will arise this year from the decision to bring forward a pay increase under the Lansdowne Road Agreement which foresees a gradual reversal of wage and pension cuts introduced for public servants. Deficit-increasing measures are partly covered by higher excise duties on tobacco and by tax compliance measures. Moreover, sustained economic growth and favorable financing conditions should help to reduce the budget deficit to 0.3% of GDP this year. Our expectation is underpinned by Ministry of Finance data from the end of Oct-17, indicating that the government is on track to meet its deficit target. While expenditure turned out somewhat lower than budgeted, revenue was in line with expectations.

Going forward, we expect that Ireland's new government, which has been in office since mid-2017, will remain committed to fiscal consolidation. In May-17, PM Kenny (Fine Gael) stepped down and former minister for social protection Leo Varadkar (Fine Gael) was elected prime minister. Our assumption of policy continuity is underpinned by the government's 2018 budget draft, which envisages a broadly balanced budget by 2019. As regards next year, net borrowing should amount to 0.2% of GDP, with the government maintaining its fiscal policy stance. Accordingly, authorities envisage moderate tax relief while boosting public investment at the same time. Voted gross fixed capital expenditure should grow by 17.4% in 2017 and reach EUR 5.3bn. Alongside higher investment in infrastructure and social housing, additional funds are allocated to health- and childcare. In view of buoyant growth perspectives in 2018 and a track record of fiscal outperformance in recent years, we expect Ireland to comply with its budgetary targets next year.

Having said this, Ireland still faces challenges with regard to public finances. Firstly, the government exhibits a relatively narrow tax base due to the application of income tax

credits and reduced VAT rates. Recently, the EU commission estimated that Ireland's VAT policy gap was considerably above the EU-28 average. Moreover, state revenues are tilted towards CIT and PIT receipts, which we consider relatively volatile. In 2016 income and profit taxes made up for 38.6% of total general government revenue. In addition, CIT concentration remained high, with the ten largest taxpayers accounting for 37% of total CIT receipts. Thus, the composition of its revenue mix leaves Ireland vulnerable to MNE relocations and changes in international taxation standards (in particular in the US). To mitigate potential revenue shocks in the future, the 2018 budget proposes the establishment of a so called "rainy day" fund. It is envisaged to capitalize this fund with an initial EUR 1.5bn next year, before the fund volume should be stepped up by EUR 0.5bn annually from 2019 onwards.

Despite the significant reduction in government debt from its 2012 peak – from 119.6% of GDP to 72.8% in 2016 – the general government's debt-to-GDP ratio stood well above the median of our A-rated sovereigns (2016: 54.1%). Moreover, the debt-to-GDP ratio is distorted by significant GDP revisions in recent years. In 2016, both the government's debt- and interest-to-revenue ratio continued to improve; however, standing at 276.1 and 8.5%, both ratios remained among the highest in the euro area. Looking forward, we expect gross debt levels to remain on a downward trajectory, with debt-to-GDP falling below 70% by 2019. To be sure, deleveraging could proceed faster than expected against the backdrop of potential one-off revenues which are currently not incorporated in our debt projections. Firstly, Ireland could be forced to recoup taxes of up to EUR 13bn after a tax arrangement with Apple was found incompliant with state aid rules by the EU commission (Aug-16). In the same vein, additional proceeds from the re-privatization of state-owned banks could result in a steeper decline of sovereign debt. In Jun-17, the government raised EUR 3.4bn in an initial public offering of a 28.8% stake in AIB. Given the government's intention to return AIB fully to private ownership in the medium term, additional proceeds could be used to pay down government debt.

Elevated fiscal risks related to the domestic financial sector have somewhat receded in 2016-17. All major banks with state involvement reported profits in H1-17 and continued to strengthen their capital positions. As illustrated by EBA data, the CET1 ratio of the Irish banking sector reached 19.2% in Q2-17, up from 17.3% one year earlier. Meanwhile, the NPL ratio of Irish banks remained significantly above EU-28 levels (4.5%), but continued to fall, reaching 11.8% in Q2-17 (Q2-16:14.6%). NPL resolution benefited from favorable trends in property prices. On the back of the economic recovery, supply shortages and tax incentives, house prices continued to grow vividly in 2016-17. In Aug-17, house prices stood 12% above their levels one year earlier. Notwithstanding these developments, we see no signs of exuberance in the Irish housing market at the moment, as price developments are partly reflect supply shortages and both price-to-rent and price-to-income-ratios are still somewhat below their respective long-term averages. Moreover, the Central Bank of Ireland tightened its LTV limits in Jan-17, while the volume of outstanding mortgages is about 40% below its 2008 peak and is experiencing only modest growth. After nine years of contraction, lending for house purchase returned to growth in Apr-17 and has gradually strengthened since then (Sep-17:+3.0% y-o-y).

On the back of stronger mortgage lending activities, credit outstanding to private households has turned the corner. Meanwhile, loans outstanding to NFCs continue to decline, albeit at slower pace than seen in 2016. Subdued credit demand is mirroring the ongoing deleveraging in Ireland's private sector. Overall private indebtedness remains high, despite the recent decline in household and corporate debt to 215.4 and 141.7% of GDP in Q2-17 (Q2-16: 262.2 and 146.2% of GDP). In nominal terms, corporate and household debt were down by 12.8 and 3.1% y-o-y, respectively. Apart from private sector deleveraging, lending is hampered by comparatively high interest rates. According to ECB data, interest rates for both households and NFCs remain about 1 p.p. higher than in Italy or Spain, which are also facing serious crisis legacies. To be sure, the authorities have begun to implement reforms targeted towards facilitating access to finance for SMEs (e.g. central credit registry).

Ireland's current account remains volatile. Last year, its current account surplus, which had soared to 10.9% of GDP in 2015, decreased sharply to 3.9%, mainly due to a lower trade surplus. While the trade in goods balance fell from 43.3 to 38.4% of GDP, the deficit in the trade in services balance widened from 10.2 to 16.4% in 2016. At the same time, large MNE presence and a significant stock of foreign-owned intellectual property in Ireland's capital stock continued to generate sizeable capital outflows. Profit repatriation and royalty payments are mirrored by the Irish economy's primary deficit, which amounted to 16.8% of GDP in 2016. However, headline figures of the Irish current account should be interpreted with caution. Gross positions are distorted by business activities of redomiciled PLCs and the International Financial Services Center (IFSC), which have limited links to the domestic economy. Thus, we believe that the economy's large external debt stock, which is reflected in a highly negative net international investment position of -176.2% of GDP (2016; 2015: -195.1%), does not present an immediate threat to the domestic economy. As illustrated by IMF data, external indebtedness of the Irish economy remains high but trended downwards across all sectors in 2016. Importantly, refinancing risks are somewhat mitigated by the composition of the external debt stock. In Q4-16, intercompany lending, which we regard as a relatively stable source of funding, accounted for more than 30% of external debt. Furthermore, most of the external debt of the government and the private sector was long-term debt.

Rating Outlook and Sensitivity

Our Rating outlook on the long-term sovereign rating is positive, as we assume that the risk situation underlying the key factors affecting sovereign credit risk – including macroeconomic performance, institutional structure, fiscal sustainability, and foreign exposure – is likely to improve over the next 12-18 months.

We could consider raising our ratings on the Irish Republic if the economy remains on its current growth trajectory, accompanied by further employment gains and improving asset quality in the banking sector. Moreover, sustained budget consolidation buttressed by measures to broaden the tax base could result in a rating upgrade.

Contrarily, we could revise our outlook to stable if Irish growth surprised on the downside. Firstly, the high degree of trade openness leaves the economy susceptible to a slowdown of growth in the US and the EU. In particular, the Irish economy is highly exposed to economic developments in the UK, given strong trade and financial linkages. Thus, prolonged uncertainty concerning the timeline and content of a prospective EU-UK-trade agreement, as well as a so called "hard Brexit", would likely have serious adverse effects on exports, investment and GDP growth. In the same vein, changes in global and particular US corporate taxation could endanger the country's attractiveness for FDI and also have negative repercussions on state revenues, which could impede budget consolidation. That said, we could revise our outlook if we observe significant fiscal slippages or a renewed increase in public debt levels.

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Ratings*

Long-term sovereign rating	A /positive
Foreign currency senior unsecured long-term debt	A /positive
Local currency senior unsecured long-term debt	A /positive

*) Unsolicited

Economic Data

[in %, otherwise indicated]	2012	2013	2014	2015	2016	2017e	2018e
Real GDP growth	0.0	1.6	8.3	25.6	5.1	4.7	3.8
GDP per capita (PPP, USD)	46,060	47,427	52,142	65,679	69,276	72,632	75,791
Inflation rate, y-o-y change	1.9	0.5	0.3	0.0	-0.2	0.3	0.7
Default history (years since default)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a	n.a
Life expectancy at birth (years)	80.8	81	81.3	81.5	n.a.	n.a	n.a
Fiscal balance/GDP	-8.0	-6.1	-3.6	-1.9	-0.7	-0.3	-0.2
Current account balance/GDP	-2.6	2.1	1.6	10.9	3.9	n.a	n.a
External debt/GDP	974.1	869.0	841.0	829.7	731.2	n.a	n.a

Source: International Monetary Fund, World Bank, Eurostat, own estimates

Appendix

Regulatory Requirements

This sovereign rating is an unsolicited credit rating. National Treasury Management Agency (NTMA) participated in the credit rating process as the authorities commented on a draft version of this report. Thus, the report represents an updated version which was augmented in response to the factual remarks of NTMA. The rating outcome as well as the related outlook remained unchanged.

The rating was conducted on the basis of CRAG´s "Sovereign Ratings" methodology. CRAG ensures that methodologies, models and key rating assumptions for determining sovereign credit ratings are properly maintained, up-to-date, and subject to a comprehensive review on a periodic basis. A complete description of CRAG´s rating methodologies is published on the following internet page: www.creditreform-rating.de.

To prepare this credit rating, CRAG has used following substantially material sources: International Monetary Fund, World Bank, Organization for Economic Co-operation and Development, Eurostat, European Commission, European Banking Authority, European Central Bank, Central Bank of Ireland, Central Statistics Office, Republic of Ireland/ Department of Finance

A Rating Committee was called consisting of highly qualified analysts of CRAG. The quality and extent of information available on the rated entity was considered satisfactory. The analysts and committee members declared that the rules of the Code of Conduct were complied with and that the rating action was and is free of any existing or potential conflicts of interest. The analysts presented the results of the quantitative and qualitative analyses and provided the Committee with a recommendation for the rating decision. After the discussion of the relevant quantitative and qualitative risk factors, the Rating Committee arrived at a unanimous rating decision. The weighting of all risk factors is described in CRAG´s "Sovereign Ratings" methodology. The main arguments that were raised in the discussion are summarized in the "Reasons for the Rating Decision".

In the case of a rating outlook, the time horizon is provided during which a change in the credit rating is expected. This information is available within the credit rating report.

There are no other attributes and limitations of the credit rating or rating outlook other than displayed on the CRAG website. In regard to the rated entity CRAG regarded available historical data as sufficient.

In case of providing ancillary services to the rated entity, CRAG will disclose all ancillary services in the credit rating report.

In accordance to Article 11 (2) EU-Regulation (EC) No 1060/2009 registered or certified credit rating agency shall make available in a central repository established by ESMA information on its historical performance data, including the ratings transition frequency, and information about credit ratings issued in the past and on their changes. Requested data are available on the ESMA website: https://cerep.esma.europa.eu/cerep-web/statistics/defaults.xhtml.

An explanatory statement of the meaning of CRAG`s default rates are available in the credit rating methodologies disclosed on the website.

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