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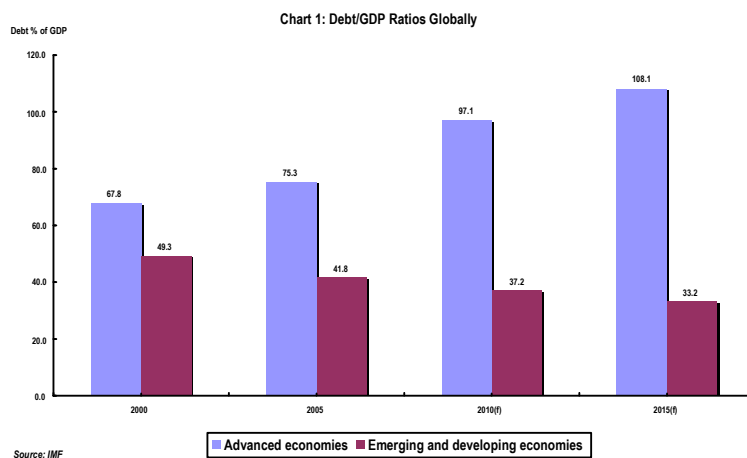
15th October 2010



The debt unwind – will it hurt?

Lately we have seen a huge amount of commentary on the rising cost of Irish debt and the need for Ireland to cut its budget deficit and debt levels generally. However, it is important to put Ireland's situation into perspective. This is not just an Irish specific problem but a western world problem. A key follow up question arising from this issue is whether high debt levels will jeopardise the global economic recovery and how these budget deficits should be tackled.

The global recession and credit crisis is likely to mean that the economic recovery in the west is likely to be less robust than in previous recovery cycles. There is some evidence behind this view, particularly in the writings of Carmel Reinhart and Kenneth Rogoff*. Earlier in the year they showed (using a sample of 20 advanced nations over the past 200 years), that economic growth rates were around 2% lower when debt/GDP ratios were 90%+ compared to when debt/GDP ratios were 30% or below. In contrast, when we look at the Asian and Emerging economies, growth is strong and these nations don't have debt problems. Chart 1 below reiterates the 'low debt' point.



As we have pointed out before, the developing economies will provide a lot of ballast for the world economy at a time when the west is struggling with debt issues. Overall, solid growth rates of around 3% should still be achievable globally. This very much underpins our view that risk assets can outperform government bonds and cash in the medium term, particularly given current valuations and near zero interest rates.

In the short term investors remain firmly focused on the issue of budget deficits (particularly in Ireland), how they can be reined in and what the short term impact on growth will be. In its Economic Outlook this month, the IMF looked into this issue** and its broad conclusions have important implications for Ireland;

- Cuts to budget deficits typically reduce economic output in the short term but longer term the results are positive
- Reductions in interest rates and currency devaluations play a key role in offsetting the impact of budgetary contractions. This is important for Ireland - Ireland needs to continue to deflate costs to improve competitiveness as it can't manufacture a euro devaluation.
- Budgetary contractions that focus more on spending cuts (rather than tax increases) tend to lead to smaller losses in economic output and lead to smaller increases in unemployment. Spending cuts in items like public sector pay have a particularly positive impact as they signal a credible commitment to reducing the budget deficit. Again, this is very relevant in an Irish context.

Our View

Overall, despite all of the investor concerns that have buffeted capital markets, the global economic recovery has continued as the year has progressed.

There are challenges to the medium term recovery, many of which result directly from the credit crisis. However, while high debt levels will tend to constrain growth in the western world, Asia and the Emerging Markets will help cushion this blow.

We believe that risky assets can outperform cash and government bonds in this environment.

The continued recovery in the global economy is vital for a recovery in the Irish economy. The budgetary measures that are required in Ireland over the medium term will be very tough but are necessary. Along the way, we need to continue to improve competitiveness. A much weaker euro would also be very helpful.

Tom McCabe, CFA
Investment Manager

*Growth in a Time of Debt, National Bureau of Economic Research – January 2010
**Will it hurt? Macroeconomic effects of fiscal consolidation – IMF World Economic Outlook, October 2010

Focus

Bank of Ireland



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