Economic outlook:
Recession redux

Atradius Economic Research
Group Risk Management
Quarter 1 2009

Contents

All views expressed here are those of Atradius Economic Research and represent ongoing research into the determinants of corporate insolvency and the impact of the economic cycle within Atradius. The views do not represent an expression of intent and should not be seen as investment advice.

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Executive summary

- ***Economic conditions deteriorated very seriously in the fourth quarter of 2008.*** *Recessionary conditions exist in all major markets. The downturn is now global.*

- ***The global financial system is very fragile.*** *One and a half years after the onset of the crisis, despite extensive bail-outs and nationalisation, the banking sectors of both developed and emerging markets continue to face severe pressure. As the recession deepens the attritional credit losses more typically associated with a downturn will continue to limit the scope of their lending activity.*

- ***Stock markets are facing downward pressure and credit spreads remain elevated.*** *The sharp reversal in real economic activity is now clearly visible. The corporate sector has scrambled to adjust and is rapidly driving up unemployment in several countries in the process, putting further pressure on aggregate demand. The vicious combination of widespread financing difficulties and falling demand translates into deteriorating perceptions of credit risk.*

- ***The capacity for fiscal stimulus is narrowing.*** *Large-scale nationalisation of commercial banks and extensive credit guarantees to the private sector are now weighing heavily on public finances in the United States and several European countries.*

- ***Expectation of a deep recession translates into a significantly worsened insolvency environment for the entire global corporate pool.*** *Insolvencies are predicted to increase steeply across major markets in 2009. Emerging market corporates face similar challenges, while rising political risks add an additional tier of uncertainty. Banking system weaknesses and macroeconomic imbalances, in particular across Eastern European and CIS countries, leave many countries extremely vulnerable in the current economic climate.*

- ***Is economic recovery expected to take place in 2010?*** *Given current expectations for a deep economic contraction in 2009, the downturn will probably prove to be protracted. Strong persistence in insolvency dynamics means that the corporate payment environment is likely to deteriorate further, over several years.*

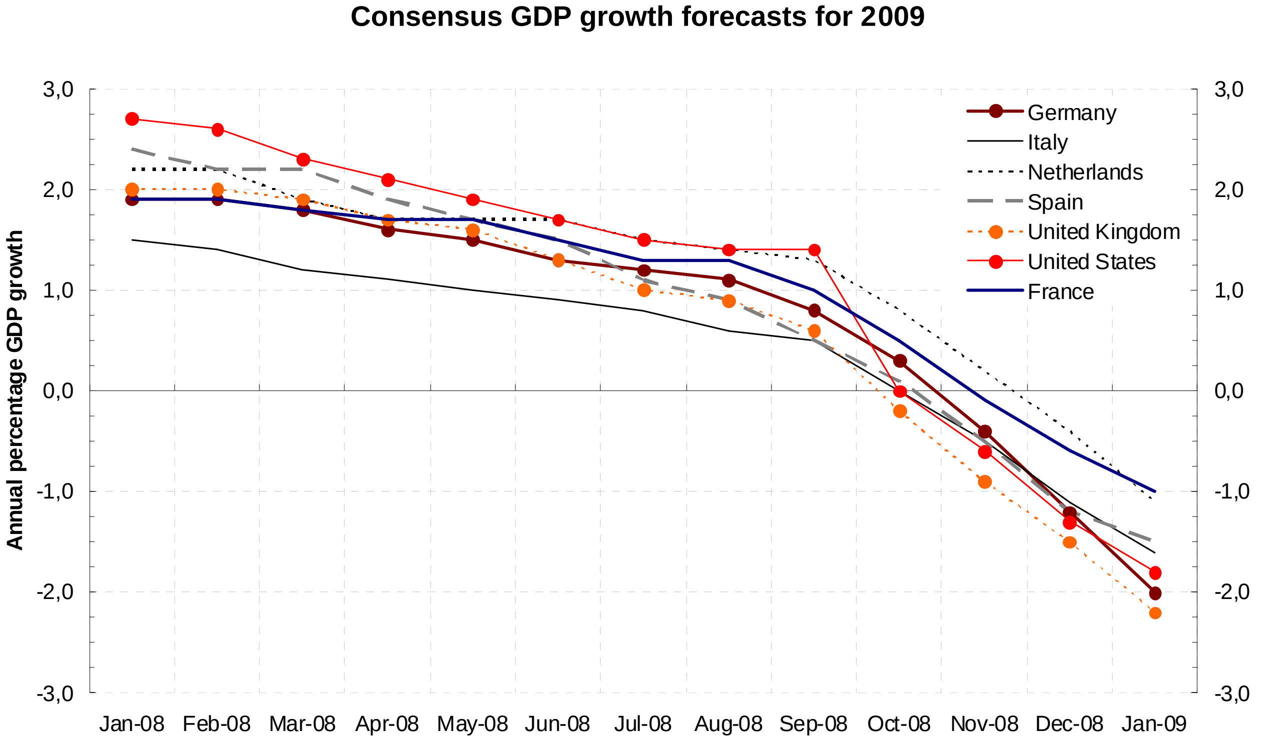
The global economy has entered into recession…

	Consensus Forecast January 2009 Survey	Real GDP % Growth					
		2007	2008	2009	2010	2009 Trend	2009 M-o-M forecast revision
Major Markets	France	2.1	0.8	**-1.0**	0.9	↓	↓
	Germany	2.5	1.3	**-2.0**	0.8	↓	↓
	Italy	1.4	-0.5	**-1.6**	0.5	↓	↓
	Netherlands	3.5	2.0	**-1,1**	0,6	↓	↓
	Spain	3.7	1.2	**-1.5**	0.4	↓	↓
	United Kingdom	3.0	0.8	**-2.2**	0.6	↓	↓
	United States	2.0	1.2	**-1.8**	2.3	↓	↓
Major Regions	Western Europe	2.8	0.9	**-1.5**	0.8	↓	↓
	Eastern Europe	7.0	5.0	**2.0**	-	↓	→
	Euro zone	2.6	0.9	**-1.4**	0.8	↓	↓
	Asia Pacific	6.3	4.0	**2.0**	4.3	↓	↓
	Latin America	5.5	4.4	**1.4**	-	↓	→
	World	3.9	2.3	**-0.2**	2.0	↓	↓

Sources: Consensus Forecasts (Survey date 12 January); Atradius Economic Research.

- *The latest GDP figures make it clear that, compared to 2007, economic activity slowed considerably across all major markets in 2008. The speed of the deterioration was particularly fast in the latter half of the year.*
- *2009 is now widely expected to be an exceptionally bad year in terms of economic activity. Forecasts suggest that all major economies will contract.*
- *A rebound in economic activity is expected to take place in 2010, although the January consensus forecasts make it clear that, other than in the US, the recovery is likely to be slow. Given the poor health of the global economy and the uncertainty surrounding current forecasts, this assessment should be treated with caution.*

…and growth forecasts continue to fall

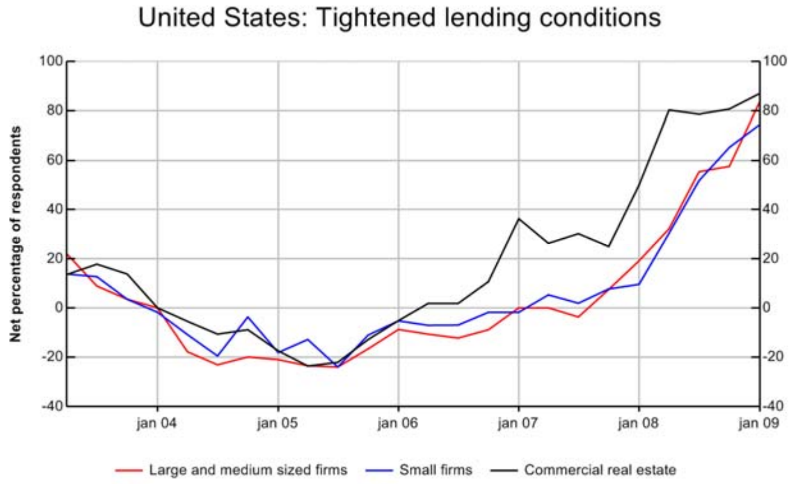


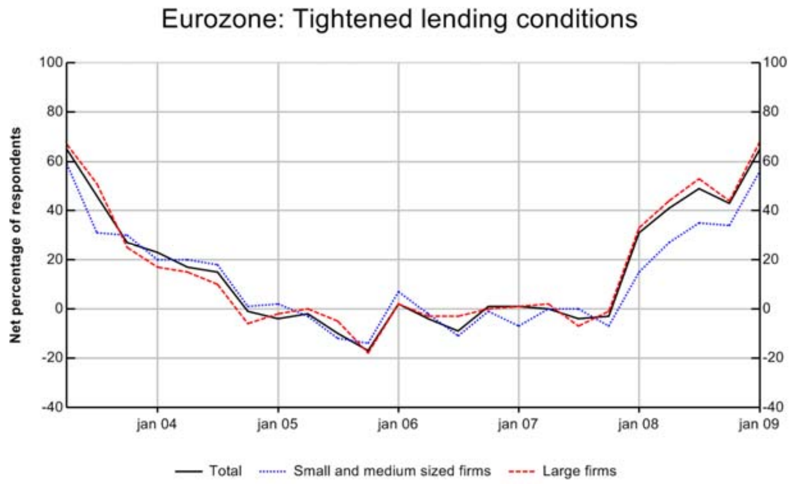
Sources: Consensus Forecasts; Atradius Economic Research.

Note: Consensus GDP growth forecasts for 2009 from 13 consecutive surveys (between January 2008 and January 2009).

- *There is substantial downside risk to the consensus scenario.*
- *Growth forecasts for 2009 have been regularly adjusted downwards throughout 2008. The consensus expectation for annual growth in 2009 fell by approximately 3-4 percentage points across all major markets over the course of the year.*
- *As of January, the consensus expectation for US growth in 2009 fell to -1.8 percent. Similarly, the UK economy is expected to contract -2.2 percent. Further downward adjustments are to be expected.*
- *The Consensus figures represent the average view and several major forecasters expect the depth of contraction to be more severe.*

Credit conditions remain tight as banks struggle…





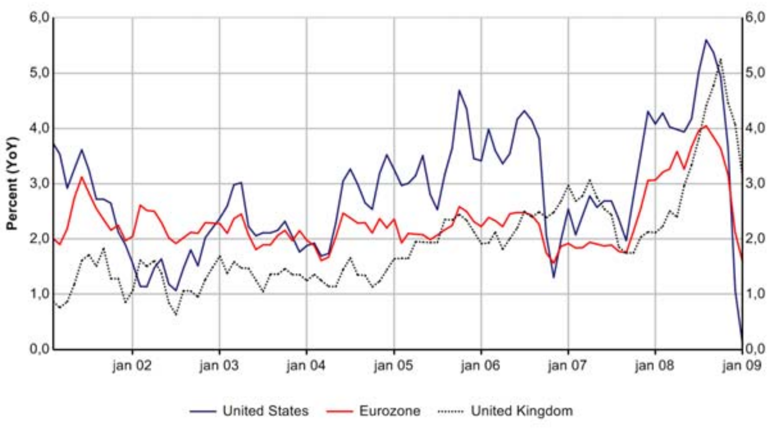
- *The corporate sectors across nearly all major markets continue to face tighter credit conditions as is evident from regular bank lending surveys.*
- *The sharp tightening effect appears to be roughly equivalent for large firms and SMEs alike.*
- *The Eurozone and the US are experiencing similar conditions with regard to bank credit. The UK also demonstrates a clearly negative trend.*
- *This tightening process has been accelerating since the 4th quarter of 2007. The cumulative effect of several consecutive quarters of net tightening is now significant.*
- *The tightening reflects the depleted capital positions of financial institutions who are now struggling to extend new credit. Additionally, the general perception and credit worthiness of firms has deteriorated sharply, which further inhibits lending activity.*
- *Despite large-scale public intervention to support financial institutions, we can expect the tightening to continue for an extended period.*

Sources: Federal Reserve; European Central Bank; Global Insight; Atradius Economic Research.

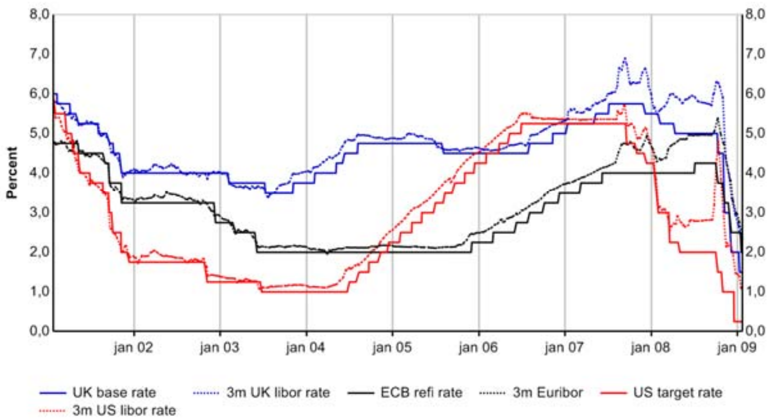
Note: The bank lending surveys of credit market conditions based on responses of banks give a view of whether credit market conditions are getting tighter or easier. Tightening credit conditions are reflected by higher positive net percentage in the charts. Last: 2008 Q4.

…and policy makers try to increase stimuli

Consumer price inflation



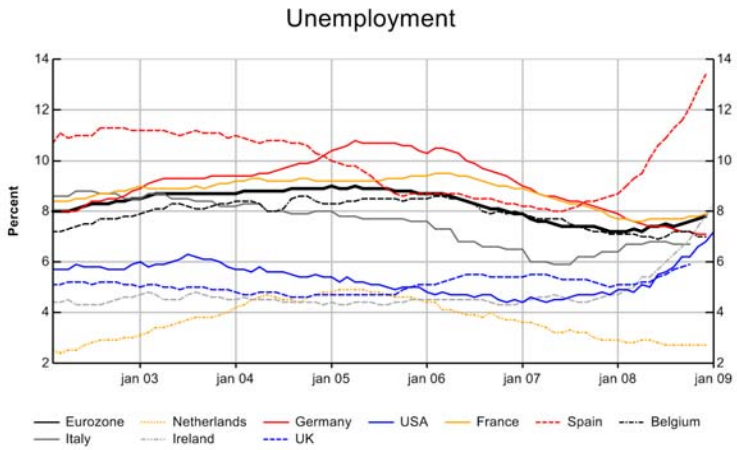
Policy and interbank rates



Sources: Global Insight; Atradius Economic Research.

- *The slump in economic activity, reflected in declining consumption, falling asset values and slower rates of credit growth, is feeding into expectations of lower consumer price inflation.*
- *The sharp reduction in energy prices that took place in the second half of 2008 has had a significant impact on the price level, driving inflation significantly lower.*
- *Instead of previous fears of rapidly rising inflation there is now a tangible risk of deflation (i.e. negative consumer price inflation) across major markets.*
- *At the same time large firms are unable to raise liquidity through the commercial paper market and the lack of bank funding for firms is persistent.*
- *Monetary policy has, as a result, turned very accommodative, with aggressive lowering of short term interest rates. The Federal funds rate has been cut to virtually zero. Several additional measures of quantitative easing to bring down lending rates are in the process of being implemented.*
- *Funding costs remain elevated for banks despite the aggressive monetary policy easing. Furthermore, the interest rate reductions are not being passed on to corporate and household borrowers.*

A negative spiral as both firms and consumers retrench

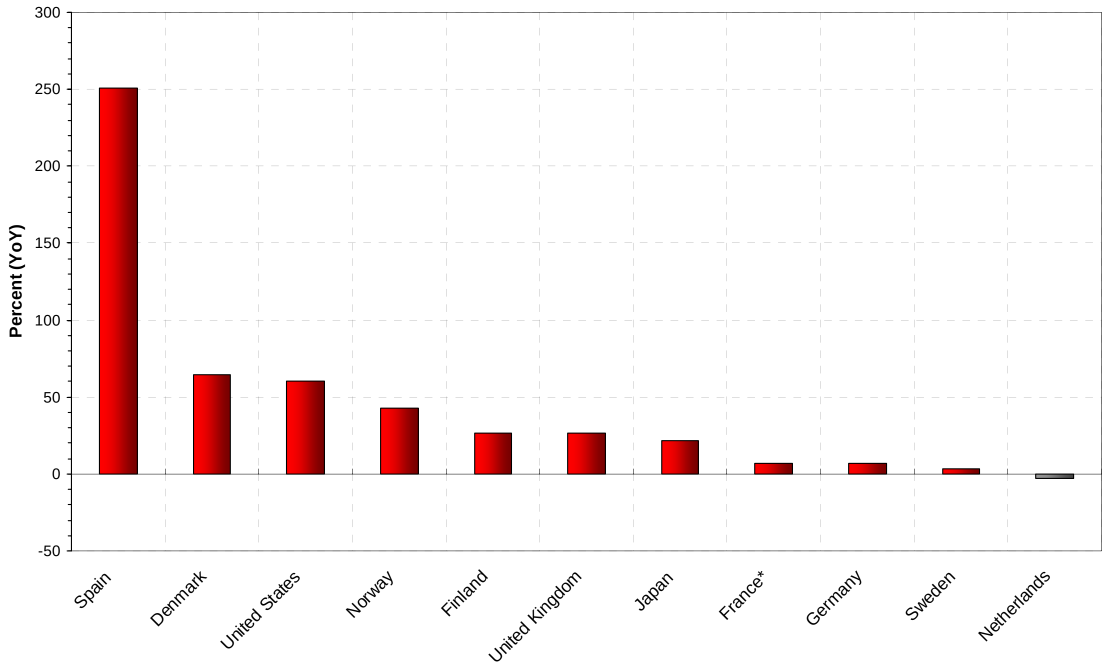


Sources: Global Insight.

- *Given that the credit crisis originated in the housing market, it is not surprising that house price growth has become a key indicator in assessing the depth of the downturn. In particular, falling collateral values affect the ability of households to finance consumption through borrowing.*
- *In the US, house prices are still falling after 9 quarters of steady decline. House prices are also falling back across several European markets, in particular in the UK and Ireland. Sharp price deceleration is being experienced across virtually all European markets.*
- *These developments are weighing heavily on consumer confidence which, combined with tighter credit conditions, are inducing further falls in consumption growth.*
- *With consumption falling, the revenue growth of firms is under severe pressure. Aggregate profits fell considerably in the fourth quarter of 2008. Unemployment is increasing in response to the weak economic climate as firms retrench (i.e. downsizing on a broad scale).*
- *In light of the increasingly gloomy outlook, firm level adjustments to the weaker environment will continue to fuel unemployment, leading to further contraction.*

A widespread deterioration in the insolvency environment…

Insolvency growth in 2008 Q3

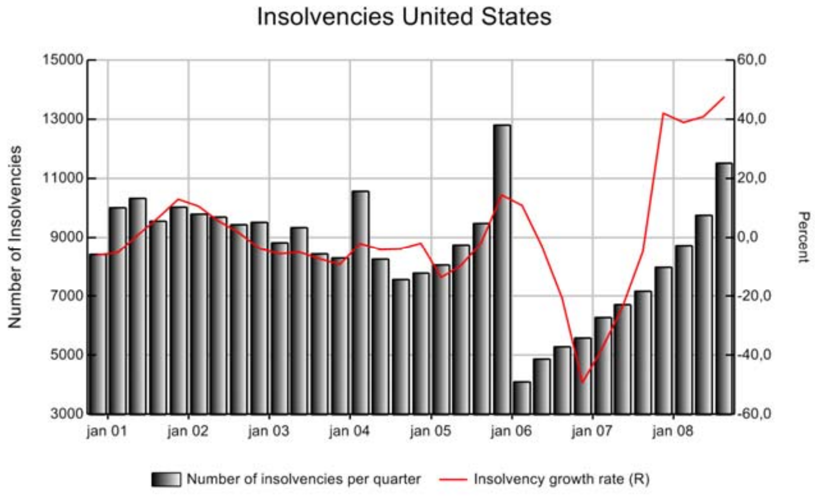


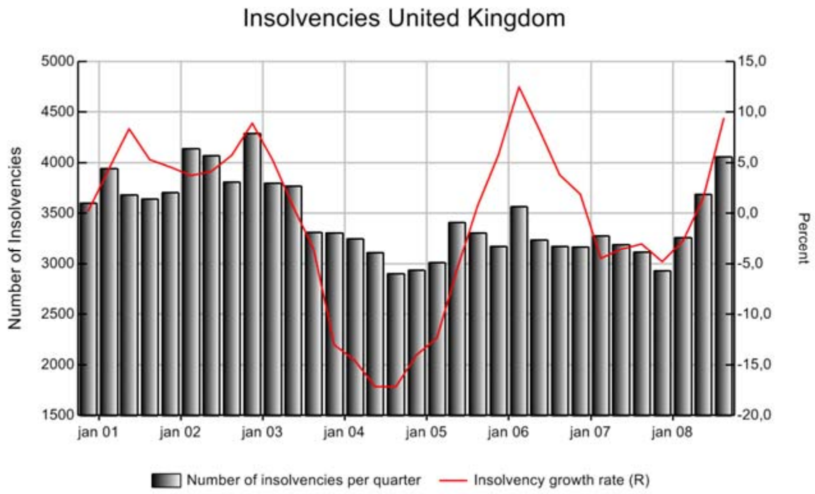
Sources: Global Insight; Atradius Economic Research.

Note: The insolvency growth rates in the chart represent the percentage change in quarterly total insolvency counts (expressed as year-on-year growth). Missing monthly values for France have been imputed in the growth rate calculation.

- *A snapshot of the insolvency environment across major markets at the end of the 3rd quarter last year shows widespread deterioration.*
- *Developments in Spain have been particularly dramatic, with a 250% year-on-year increase in insolvencies in 2008Q3.*
- *The Netherlands is the only country, above, to still display a year-on-year improvement in insolvency growth. From monthly data, however, it is now apparent that insolvencies are increasing.*
- *The 2009 insolvency outlook for all markets displayed above is clearly negative. This is consistent with increasingly negative macroeconomic and financial market expectations.*

…but regional trends differ in strength



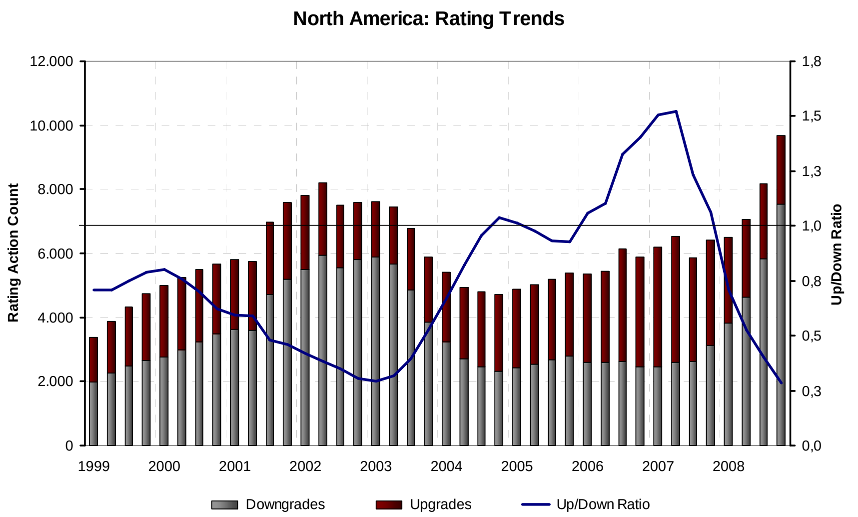


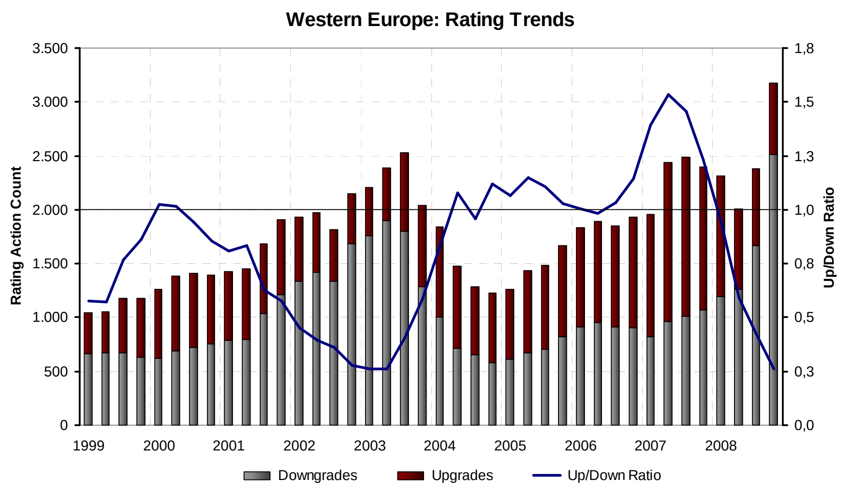
- *In the **United States** and the **United Kingdom**, where the economic downturn has been most clear, insolvency growth is now accelerating rapidly. US insolvencies amounted to more than 11,000 in the third quarter, while the UK insolvencies reached more than 4,000.*
- *Insolvency growth accelerated tremendously in **Spain**, consistent with the poor economic performance. The situation is less acute in **France**, although insolvency growth is picking up there as well.*
- *Similarly, the insolvency trend in the **Nordic region** turned negative in the second half of 2008. **Denmark**, which has struggled with weak economic performance since 2007, shows the steepest deterioration. Insolvencies are also increasing in Norway, Sweden and Finland.*
- *In **Germany** and the **Netherlands** the insolvency environment is beginning to turn. Insolvencies bottomed out in mid-2008 and there is now compelling evidence that a turn in the cycle has taken place and that firm failures are rising.*
- ***Japan** has displayed a steady increase in the number of insolvencies over a number of years, and that trend is set to continue in the current climate.*
- *We expect insolvency growth to increase further across all of these markets.*

Sources: Global Insight; Atradius Economic Research.

Note: Insolvency counts per quarter. The growth rate represents the percentage change in annualised insolvency counts.

Corporate credit ratings are experiencing downward pressure



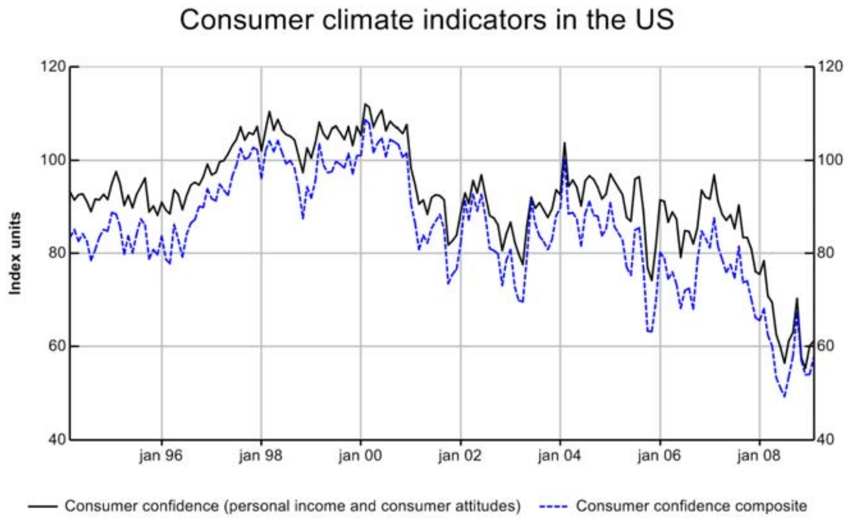


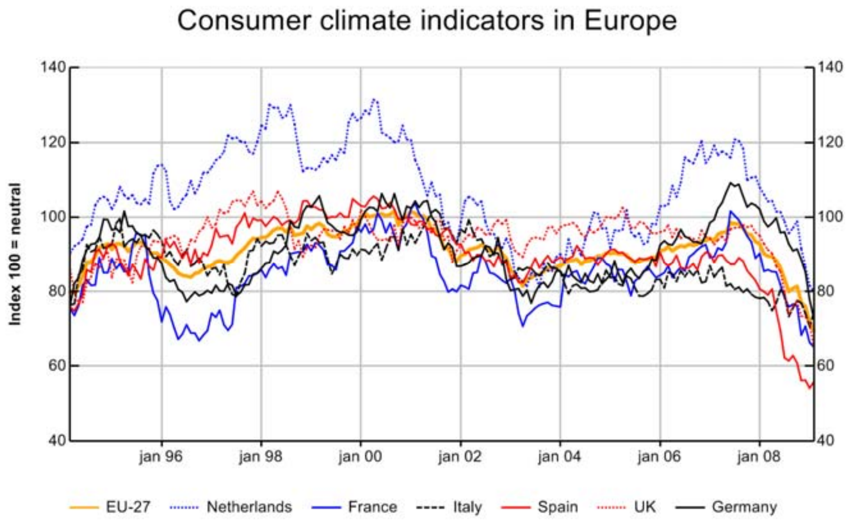
- *The activities of rating agencies summarise the general deterioration in credit quality that has taken place over the last quarters.*
- *Negative rating actions are now outstripping positive ones both in Western Europe and in the US. The ratio of positive to negative rating actions fell to just 0.3 in the fourth quarter last year, but the turning point in the cycle emerged in the beginning of 2007.*
- *The default environment within the rated universe of firms was exceptionally benign between 2004 and 2007, consistent with previous strong momentum in economic activity. The lowest default rate was recorded in 2007 at just 0.4%.*
- *The credit cycle turned sharply in 2008, with an increase in the number of large corporate defaults reported. We are now heading for a severe recession environment, the like of which was last seen in the early 1990s.*
- *During that downturn the global default rate reached 3-4%, giving some perspective in terms of what we can expect.*

Sources: Standard and Poor's; Moody's; Fitch Ratings; Bloomberg; Atradius Economic Research.

Note: Tracking the activities of rating agencies gives a good indication of the general direction in which credit quality is moving. The upgrade and downgrade actions of Moody's, S&P and Fitch are counted (moving annual total), and a ratio of the two calculated. The sample is confined to large debt-issuing companies, but nonetheless indicative of conditions generally.

The predominant market sentiment is deeply negative



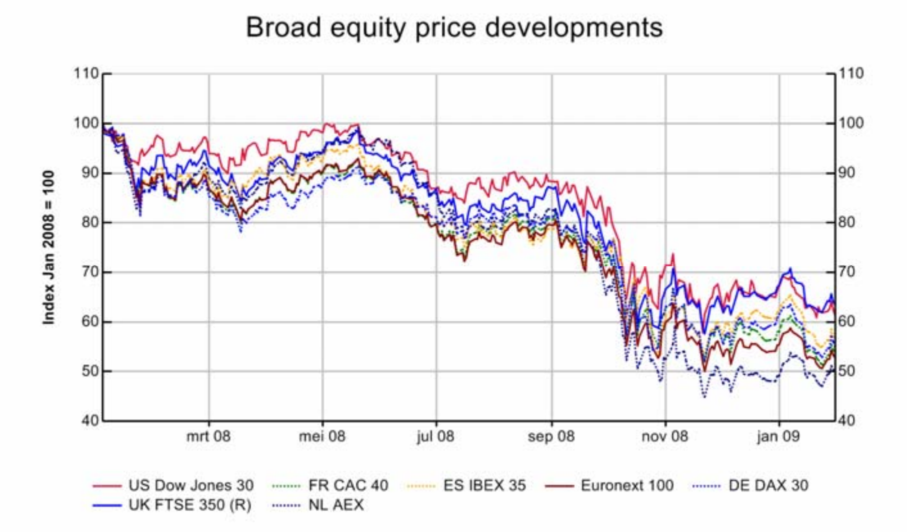


- *The current expectation of a full-blown recession is anchored by the increasingly pessimistic outlook adopted by consumers towards their own financial situation and spending intentions.*
- *The development of consumer expectations across European markets follows a steep decline in confidence since the beginning of 2008.*
- *In Spain, which has witnessed one of the most extensive slowdowns in economic activity, confidence has hit new depths. More generally, the level of confidence is comparable to previous episodes of very weak economic conditions across all markets.*
- *The Michigan index which tracks consumer confidence in the US has also performed poorly. Despite some modest recovery in recent months, the level of confidence is still hovering at historically low levels.*

Sources: Global Insight; DGECFIN; The Conference Board; Atradius Economic Research.

Note: In the ICON-Konsumbarometer a value above 100 indicates an optimism surplus among the survey respondents.

Stock price developments reflect increased downside risk…

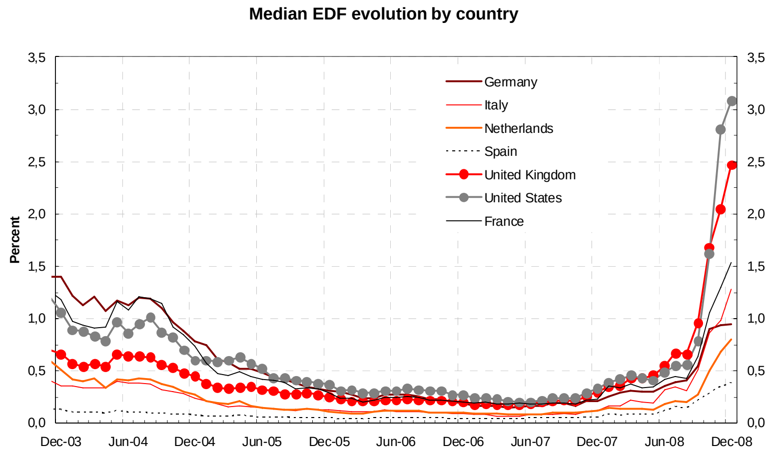


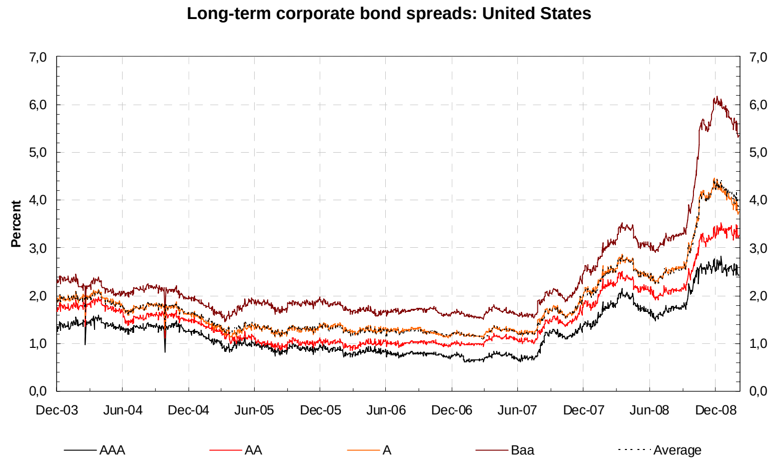
- *Diminishing expectations of corporate profitability, as revealed by their equity market valuation, has been visible across all markets.*
- *Since the beginning of 2008, equity markets have declined between 35 and 50 percent, with the largest falls taking place in October last year.*
- *Stock prices have moved sideways since November 2008 but volatility remains high, reflecting uncertainty about the global economic outlook. The effect of the downturn on corporate balance sheets is evident from fourth quarter earnings reports.*
- *Valuations are now in line with levels that prevailed in 2004. Given the steepness of the downturn there is still scope for further equity declines as earnings estimates continue to be adjusted downwards.*
- *The decline in stock prices puts pressure on financial collateral and lowers the value of firms' balance sheets. It also erodes the financial wealth of already stretched consumers.*

Sources: Global Insight; Atradius Economic Research.

Note: Rebased indices, denominated in national currencies.

…manifested in rapidly increasing expectations of insolvencies





- *Expected Default Frequencies (EDFs) have increased tremendously in recent months, signalling a steep increase in corporate insolvencies over the short term. The median corporate EDF in the US pool is now higher than 300 basis points, up from 25 basis points at the end of 2007.*
- *The deteriorating trend has been evident since mid-2007 but accelerated rapidly in the 4th quarter of 2008. EDFs are approaching levels that last prevailed during the previous downturn in 2001.*
- *Taking into account the fact that EDFs reflect the universe of large and listed companies, these trends illustrate the rapidly increasing likelihood that large scale credit events will occur. This is also consistent with the negative rating trends we observe.*
- *At the same time corporate bond spreads remain elevated, implying a persistent increase in perception of default risk across the entire debt-issuing segment. The re-pricing has been broad-based across rating categories. Firms belonging to the end of the investment grade spectrum are now facing very high costs of issuing debt.*

Sources: Moody's KMV Credit Monitor; Global Insight; Atradius Economic Research.

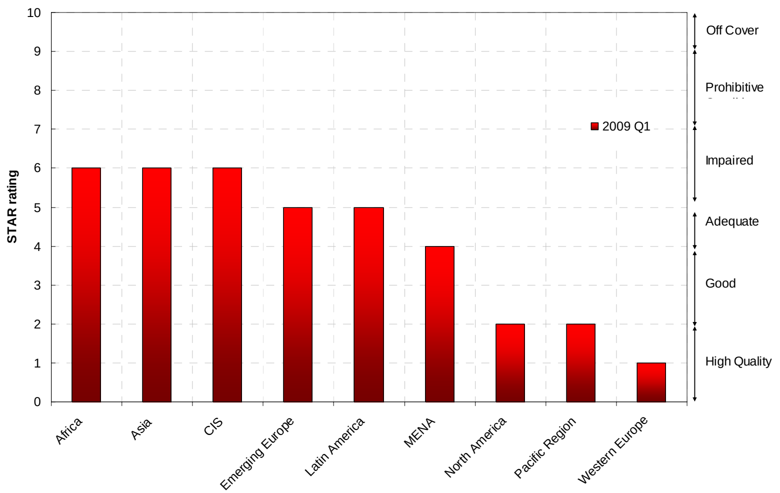
Note: 1. EDF in monthly observations from December 2003 (last: December 2008). The EDF represents a tool for tracking default risk among stock listed companies. Combining balance sheet and stock market information for a particular firm yields a 1-year ahead default forecast. The median EDF for a country represents the 50th percentile in the listed firm universe. 2. The spreads are defined as the difference between long maturity US corporate bond yields and the 10-year US government bond yield.

1. Executive summary
2. Trends in economic activity
3. The insolvency environment
4. Business confidence and market expectations
5. ***Implications for emerging markets***
6. Fiscal strains across industrialised markets
7. The correction of imbalances: the case of Ireland

Country risk continues to rise…

	Consensus Forecast January 2009 Survey	Real GDP % Growth			
		2008	2009	2010	2009 Trend
BRICS	Brazil	5.5	1.7	3.3	
	Russia	6.2	1.1	3.5	
	India	6.9	6.3	-	
	China	9.3	7.8	-	
	South Africa	3.1	2.0	3.7	
Major Regions	North America	1.1	-1.7	2.3	
	Western Europe	0.9	-1.5	0.8	
	Eastern Europe	4.6	0.6	3.1	
	CIS	6.0	1.0	3.5	
	South-East Europe	6.3	1.3	3.2	
	Central Europe	4.2	0.9	2.5	
	Asia Pacific	4.0	2.0	4.3	
	Latin America	4.3	1.0	2.8	

STAR: Median rating per region

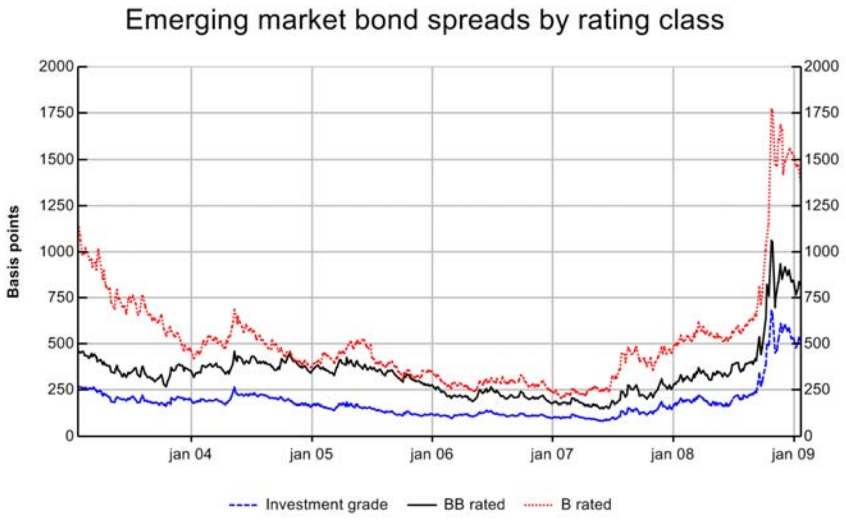


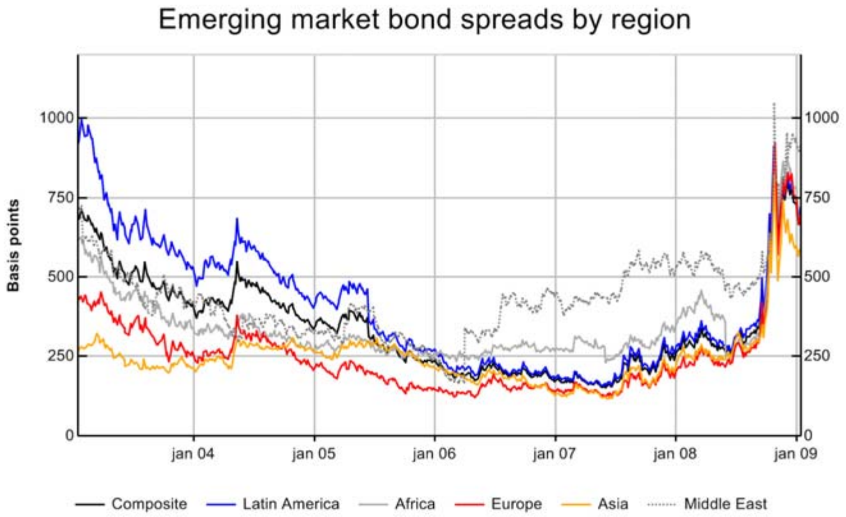
- *Deflating commodity and asset price bubbles and slowing export conditions have had negative implications for countries around the world. It is increasingly clear that recessionary conditions have not been confined to developed markets only. Economic activity slowed in 2008 and is expected to decelerate sharply across all regions in 2009. Expectations have been adjusted downwards over past months, and there is significant downside risk attached to the current scenario.*
- *Slowing economic activity of this magnitude puts many emerging markets at risk. The development path of these countries is generally fragile, reflecting weak economic and political structures. As such, the economic downturn translates into heightened political risk.*
- *A summary view of political risk can be gained through Atradius' in-house political risk rating system, the STAR (**S**overeign **T**ransfer and **A**rbitrary **R**isk), The rating evaluates the impact of macroeconomic, political and financial pressures on the ability of public and private entities to fulfill their cross border payment obligations.*
- *Ratings on a regional basis (bottom left) display our median estimates of risk in different geographical areas. Our risk perception has declined in recent months and we regard the continents of Africa, Asia and the CIS (Commonwealth of Independent States) as 'Impaired' while median risk in Emerging Europe and Latin America is seen as 'Adequate'.*

Sources: Consensus Forecasts; Atradius Economic Research.

Note: 1. Top panel: Eastern Europe and Latin American Consensus Forecasts (Survey date 19 January 2009); Asia Pacific Consensus Forecasts (Survey date 8 December 2008). 2. Median rating within each regional definition.

…reflected in elevated emerging market bond spreads



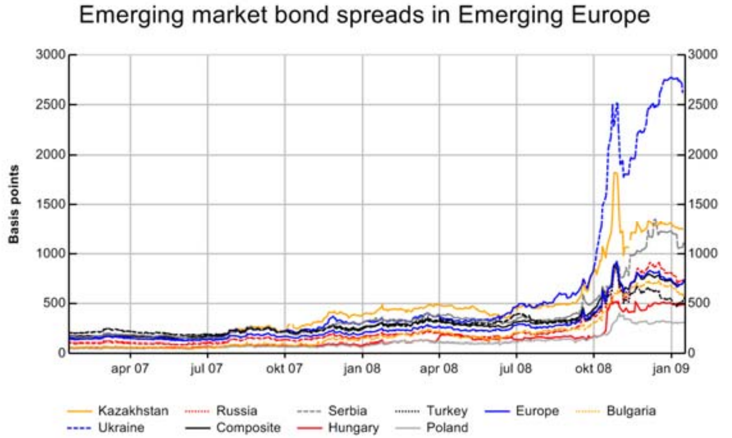


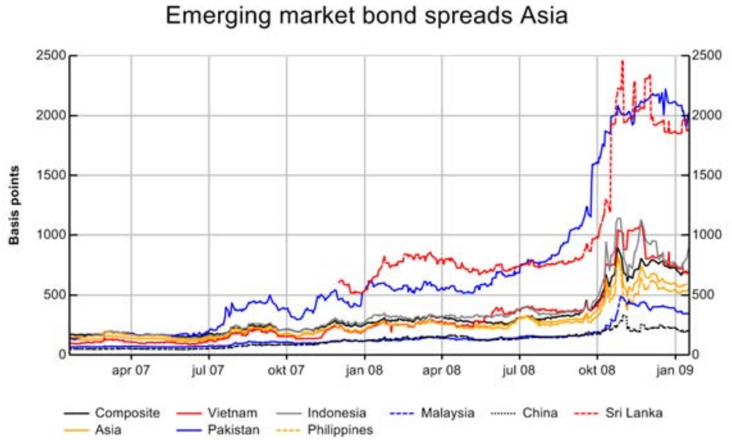
- *A number of emerging markets have experienced excessive credit creation over the past few years, relying on international bank linkages to make domestic loans. These countries now face severe macroeconomic adjustment.*
- *This is reflected in a broad-based increase in emerging market bond spreads. The weaker the country fundamentals, the sharper the increase in risk level.*
- *Bond spreads have now stabilised at levels last seen in 2003. In other words, the strong growth momentum and very benign conditions for foreign financing have come to an abrupt end.*
- *Several emerging markets that managed to get into the investment grade credit quality segment during this period run a high risk of sliding back.*
- *The speedy deterioration in economic fundamentals has fuelled political risk. Sovereign financing capacity and political stability in several markets has weakened rapidly, leading to social unrest and economic regression.*

Sources: Global Insight; JP Morgan; Atradius Economic Research.

Note: Emerging market bond indices (EMBI) track total returns (or yields) on foreign currency denominated bonds issued by sovereign governments. They are graphed here as the yield spread over US treasury bonds. Only sufficiently liquid bonds are included in the indices. Daily observations.

Widespread deterioration, but different regional triggers



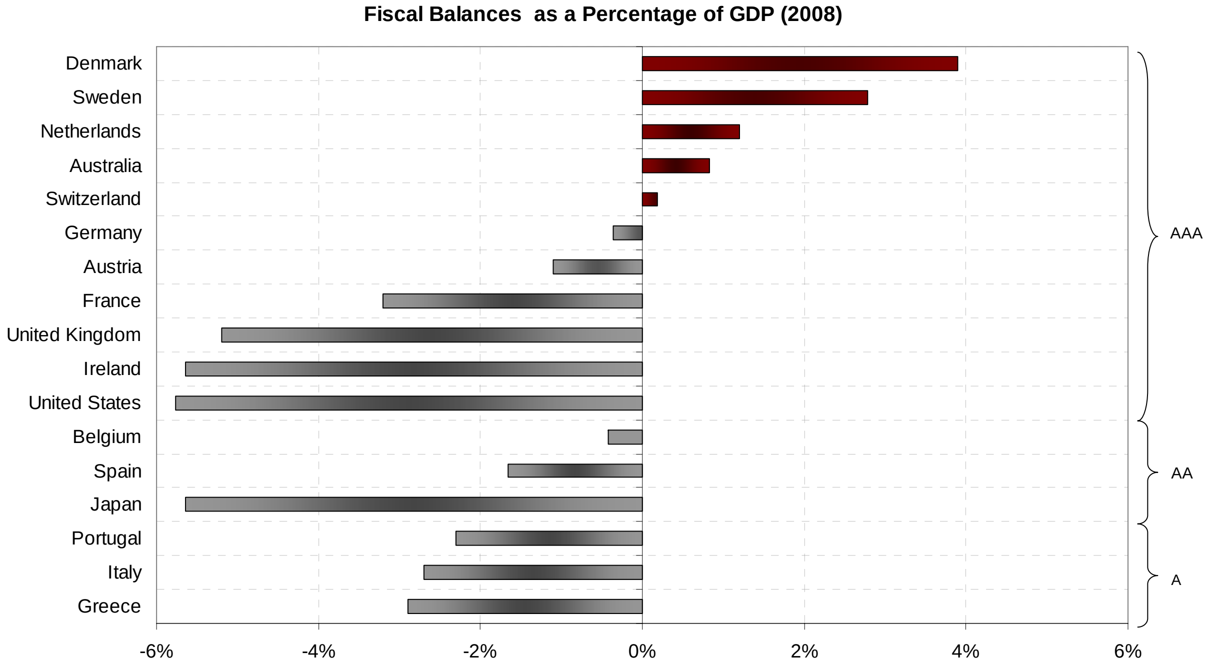


Sources: Global Insight; JP Morgan.

Note: For a definition of the spreads shown in the charts, see explanation on the previous slide.

- *East Europe experienced a dramatic change in fortune in the latter half of 2008. While a couple of countries (Latvia and Estonia) started the slide into recession as early as 2007, fears were also being expressed about the sustainability of others (e.g. Kazakhstan, Ukraine). Benign perceptions of the wider region however have changed rapidly as many businesses have had to face the harsh reality of operating in countries that have to adjust to both global and domestic imbalances. The regional experience puts emphasis on some classical macroeconomic failures and also highlights a worryingly short collective memory on the part of market participants.*
- *Asian economic risks have also risen. Several countries have built up property price bubbles over the past few years. In all these countries a property market correction is now taking place, which in turn will have a knock on effect on construction, construction materials and broader consumer demand. A sharp export slowdown can be expected from Asia. Despite deeper domestic consumption, major Asian economies remain reliant on markets in Europe and North America for credit and exports.*
- *In Central and Latin America, brisk international, regional and domestic trade has now slowed down as commodity prices have fallen. Countries such as Chile and Brazil will experience a slowdown as a result. Mexico's close integration with the US business cycle and with US industry sectors such as automotives ensures that Mexico will keep pace with the US.*

Fiscal balances are under severe strain in a number of markets…

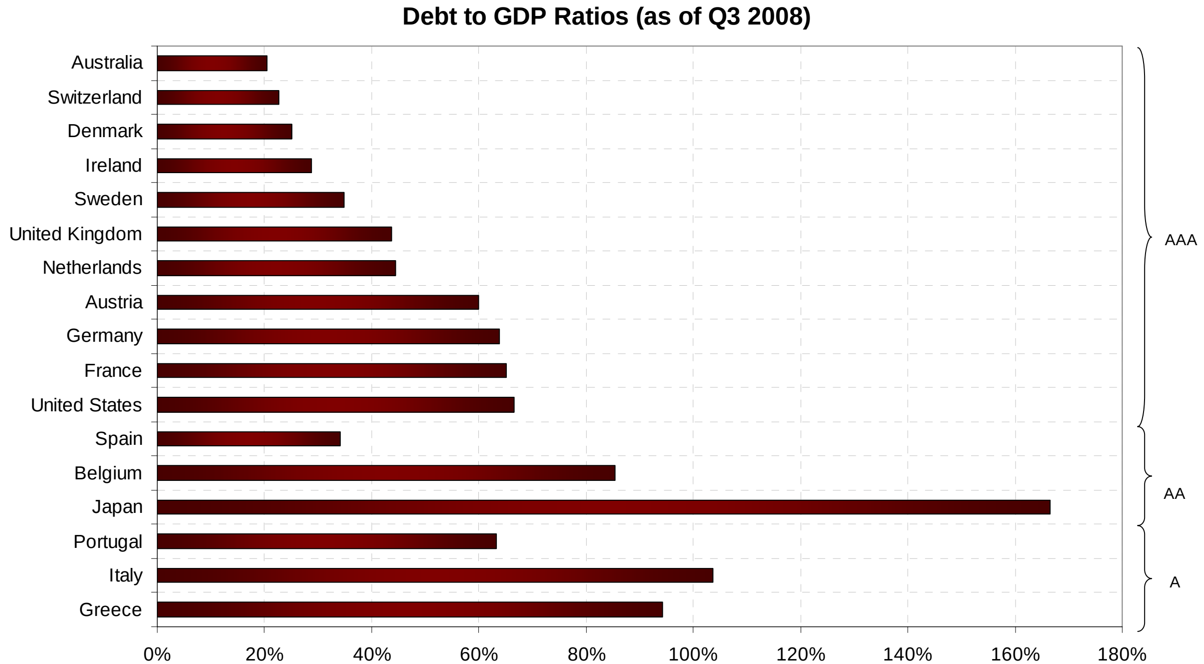


Sources: Global Insight; Standard and Poor's; Atradius.

Note: Debt-to-GDP ratios are calculated from general government debt figures. Figures for Switzerland and Australia use a narrower definition of central government debt, which excludes the liabilities of local and quasi government sectors.

- *The fiscal position of virtually every industrialised country is under pressure as a result of:*
  - *Falling tax revenues as corporate profitability and household incomes decline;*
  - *Increased spending from fiscal stimulus packages.*
  - *Rising debt service costs as governments assume the liabilities of the crisis-hit banking sector.*
- *As a consequence, fiscal imbalances are expected to deteriorate very seriously during 2009. The process will be exacerbated by sectoral imbalances in countries where governments have become excessively dependent on taxation drawn from the property, construction and financial sectors.*
- *Even with a rapid rebalancing, the consequences of the crisis will be long-lasting. The accrued debt is likely to place a significant debt service burden on budgets for years to come. Economic recovery could well be tempered in the longer term by the need to raise taxes significantly.*

…and debt levels are creeping up fast…

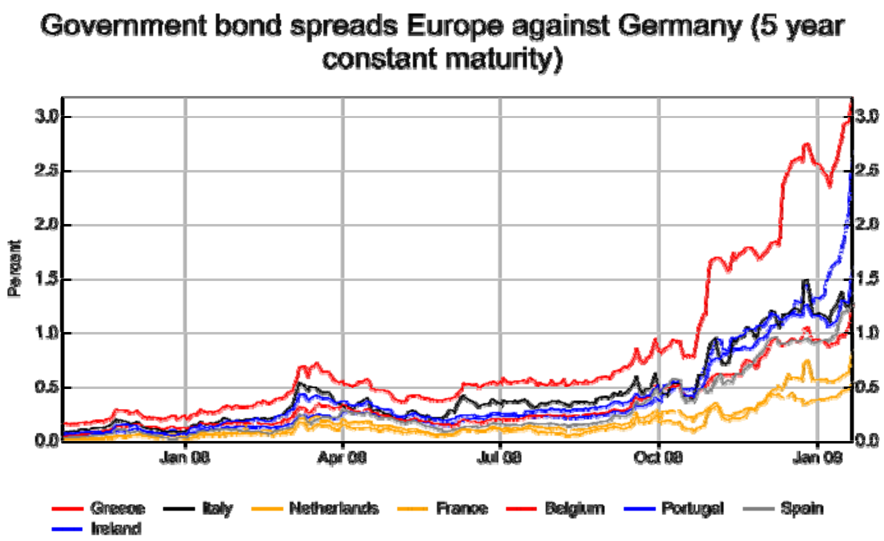


Sources: Global Insight; Standard and Poor's; Atradius.

Note: Note: Debt-to-GDP ratios are calculated from general government debt figures. Figures for Switzerland and Australia use a narrower definition of central government debt, which excludes the liabilities of local and quasi government sectors.

- *Borrowing requirements in major economies are also set to rise in 2009. Governments will have to borrow to meet commitments arising from their stimulus programmes; to compensate for the erosion of their tax base and; to meet additional commitments to help beleaguered banking sectors.*
- *The anticipated increases in government debt are, in some cases, quite substantial, particularly if the increasing levels of government financial guarantees are included.*
- *This has raised some concern about the ability of certain sovereigns to raise the requisite finance, given the sheer volume of debt issues expected and the decline in demand for issued debt.*
- *Investors are also getting increasingly concerned about the prospect of payment default in the Eurozone. This is reflected in the increase in sovereign spreads and a weakening euro. Irish sovereign five-year CDS contracts now trade at a spread of 276 basis points, higher than Greece at 254 basis points.*

…making sovereign risk a serious issue for industrialised markets



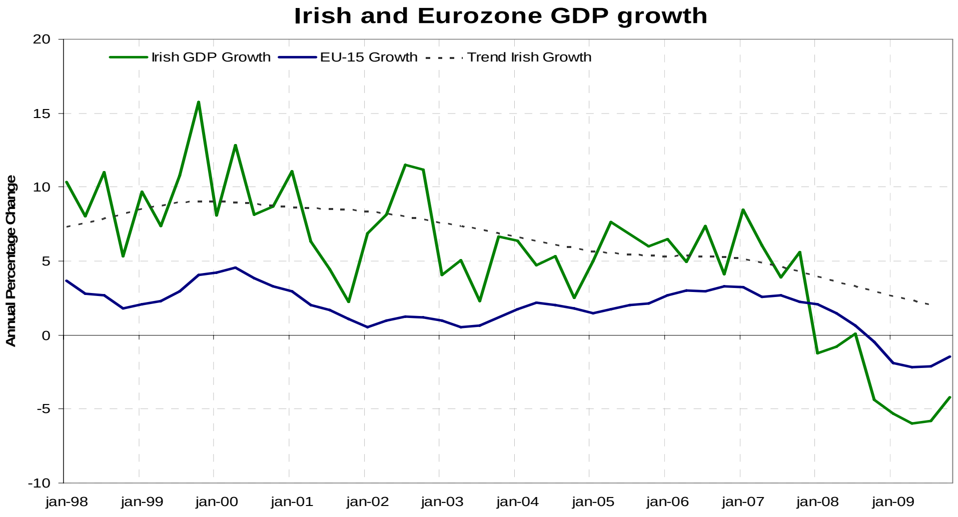
Recent Sovereign Rating Changes					
		Portugal	Ireland	Greece	Spain
Moodys	Rating	Aa2	AAA	A1	Aaa
	Outlook	◄	▼	▲	◄
Fitch	Rating	AA	AAA	A-	AAA
	Outlook	◄	◄	◄	◄
Standard & Poors	Rating	A+	AAA	A-	AA+
	Outlook	◄	▼	◄	◄

Sources: Global Insight; Bloomberg; Standard and Poor's, Fitch Ratings; Moody's Investor Services.

Note: Red highlights indicate negative movements.

- *These concerns are reflected in widening spreads between German 5-year benchmark bonds and those markets considered to be at greater risk of default.*
- *This suggests that fears are mounting over the contiguousness of the Eurozone, credit quality and liquidity across markets in the face of the severe financial crisis and recession.*
- *The European Monetary Union is facing its first critical test. Eurozone markets are at particular risk given the rigidity of an exchange rate system that prevents countries from competitive exchange rate devaluation.*
- *Consequently, the macroeconomic adjustment necessary to correct the property, credit and financial sector bubbles in certain markets will have to occur via downward asset price adjustments and a contraction in the real economy. In other words, through a fall in output, employment and wages.*
- *Though the solvency of Eurozone countries is not yet at risk, rating agencies are increasingly sensitive to the increase in debt and deficit financing. Several markets have already seen negative adjustments to their ratings.*
- *In the event of financial distress occurring in one of these markets, co-ordinated assistance would be most likely, as default by a major OECD market would have serious adverse and contagious implications for all.*

Ireland is in a deep recession which promises to be protracted

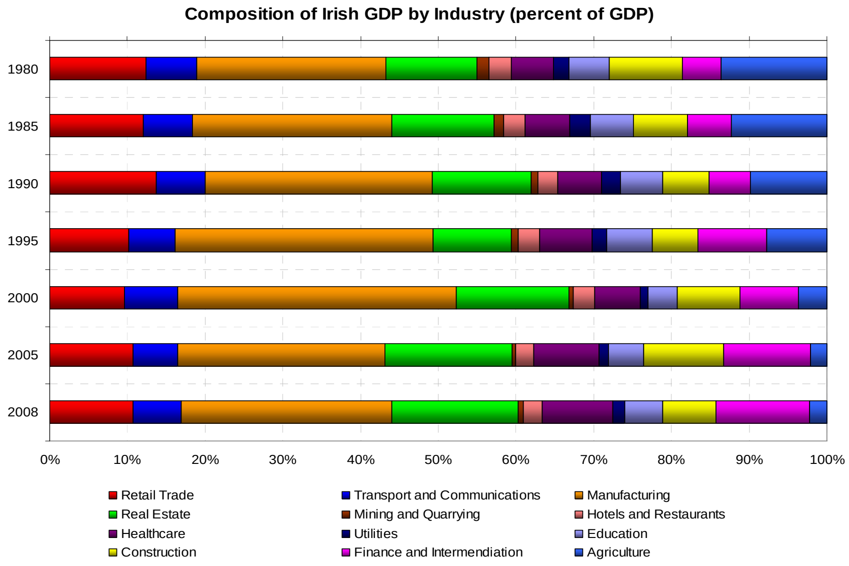


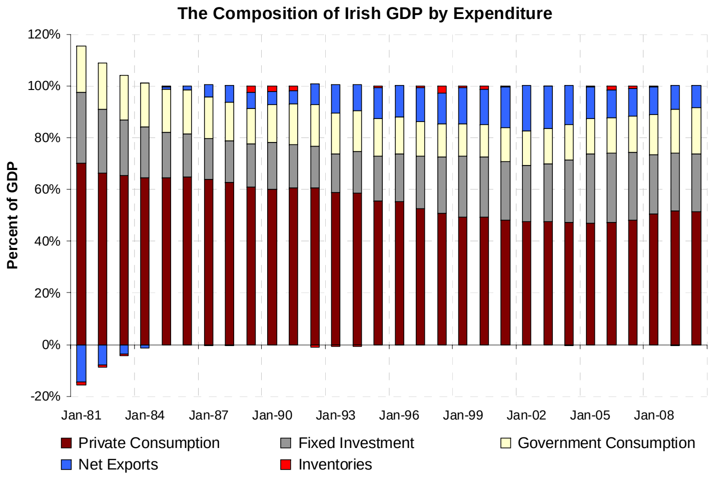
Source: Atradius Economic Research; Global Insight.

Note: Forecasts are provided by Global Insight. The growth rates are displayed in quarterly frequency, expressed in year-on-year percentage change.

- *After two decades of rapid economic growth, Ireland is now experiencing a recession that will be both steep and protracted. In 2008, the economy contracted on an annualised basis – the first time since 1986.*
- *The common view is of two years of contraction with some commentators currently forecasting 3 years.*
- *The structure of the Irish economy and its cyclical evolution over the past few years will work towards ensuring this contraction:*
  - *A small open economy, reliant on international trade and capital flows, it is heavily exposed to business cycle developments in other countries, as it is to the pricking of the credit bubble.*
  - *Strong wage increases in recent years have eroded its international productivity advantage and, in the current climate, it is faced with having to implement significant cost reductions in order to improve its productivity.*
  - *The strong correction required from overheated construction and housing sectors will add further pressure, not just to aggregate demand but also to credit, as the nationalised banking sector (and hence the government) will have to deal with large loan losses.*

Major structural changes have taken place in recent years…



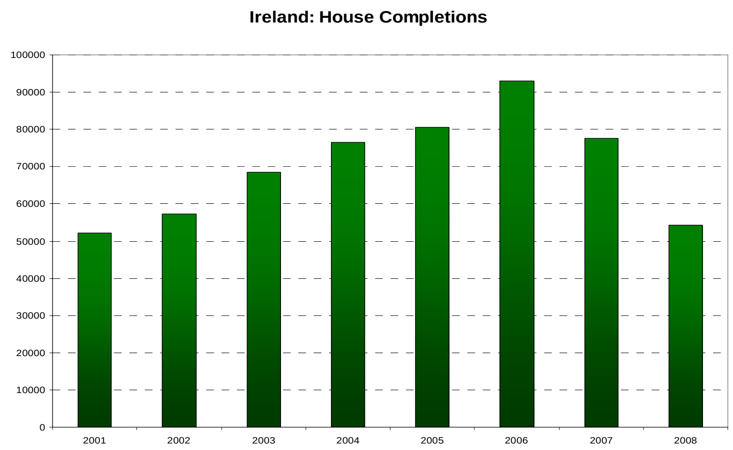


Sources: Global Insight, Atradius Economic Research.

- *During the first decade and a half of the Irish boom, growth was characterised by a sharp increase in investment and rising net exports, while private consumption, as a proportion of GDP, declined.*
- *Investment supported a rapid modernisation of the Irish economy, reflected in a sharp fall in the contribution of agriculture, and its substitution by manufacturing, pharmaceuticals and financial services.*
- *Manufacturing and pharmaceutical industries were particularly strong initially. Driven by very high levels of foreign investment inflows, the two sectors accounted for a large proportion of the rising contribution of net exports.*
- *Over the past six years however, manufacturing growth stalled and its share as a proportion of GDP has declined – falling from a high of 37% to just 25% of GDP in under a decade.*
- *Financial services and construction activity have boomed. They have risen hand in hand to support growth in the face of slower manufacturing output growth.*
- *These developments stand behind the booming housing market, the sharp increase in domestic credit and the unsustainable increase in the asset side of bank balance sheets.*

…which created a bubble in construction and housing…

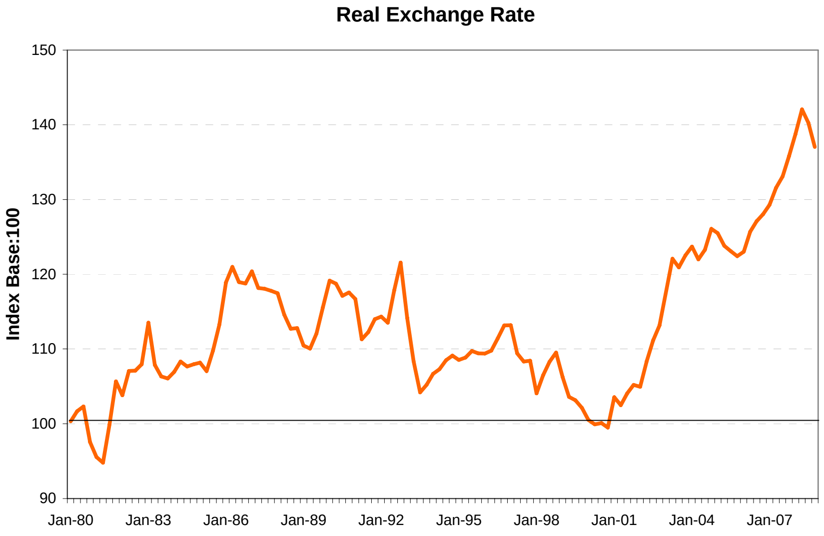
Source: Global Insight; Ireland – Department of the Environment, Heritage & Local Government; Atradius Economic Research.



References: 1. European Commission.
2. Central Bank of Ireland.

- *Ireland has enjoyed the most "dynamic" boom in house prices in recent times seen within OECD economies.*
- *Between 1992 and 2006, new house prices rose by a cumulative 300% in real terms[1]. Estimates of the degree of over-valuation in house prices at the peak of the boom vary between 20% and 40%. Rapid growth in real disposable income and easy credit conditions did much to stimulate this growth.*
- *The cycle turned in March 2007 and prices have been falling since July 2007. In real terms, the house price index has fallen by 15% since 2007Q2.*
- *This is reflected in the stalled growth of the total Irish home mortgage portfolio. After recording quarterly year-on-year rates of growth between 20% - 30% during 2005 and 2006, growth rates fell to approximately 10% each quarter over 2007 and the first quarter of 2008. As of September 2008, the year-on-year growth rate in the Irish mortgage pool stood at 2.4%[2].*
- *Housing activity also has shown a similar decline. From 1980 to the mid 1990s, housing completions averaged around 23,000 homes per year. The number then rose steadily, peaking at 93,000 in 2007 before starting to decline. 54,000 new home completions were recorded in 2008.*

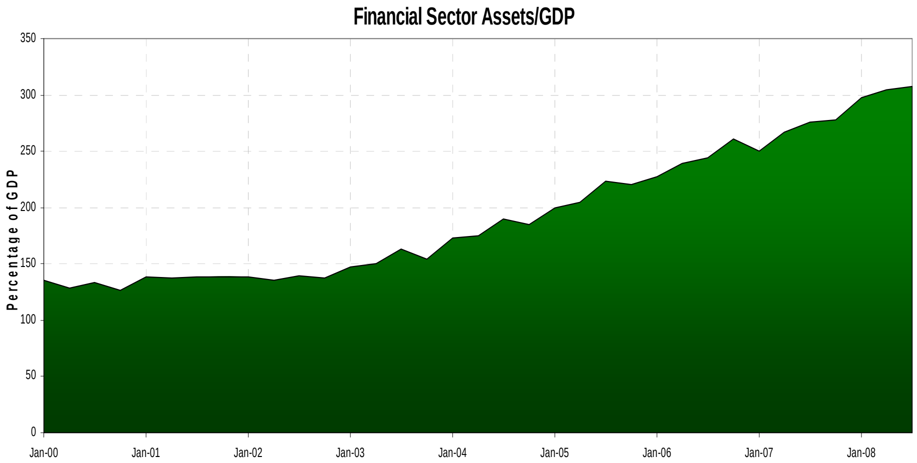
…reduced competitiveness…



Source: Atradius Economic Research; Global Insight.

- *Irish net exports have been in decline as a proportion of total GDP since the second half of 2002. This has been caused both by decelerating export growth, but also high demand for imports on the back of booming domestic demand and high commodity prices.*
- *Even taken together, the growth in exports of goods and services combined has tended to lag somewhat behind world export-market growth, implying that at the aggregate level, Irish exports have lost market share.*
- *There has been much debate as to whether the strength of the euro has harmed Irish competitiveness. There is also an issue with falling productivity given recent years of wage increases.*
- *Irish exports are heavily focused on serving OECD markets. The scale of the business cycle downturn in these markets guarantees a significant reduction in export activity. At the same time, adverse movements of the Euro against Sterling and the US dollar will reduce competitiveness. Ireland does not have the option to devalue to protect its own competitiveness.*
- *In addition, falling international profitability will reduce FDI flows into Ireland and manufacturers may speed up medium term decisions to relocate.*

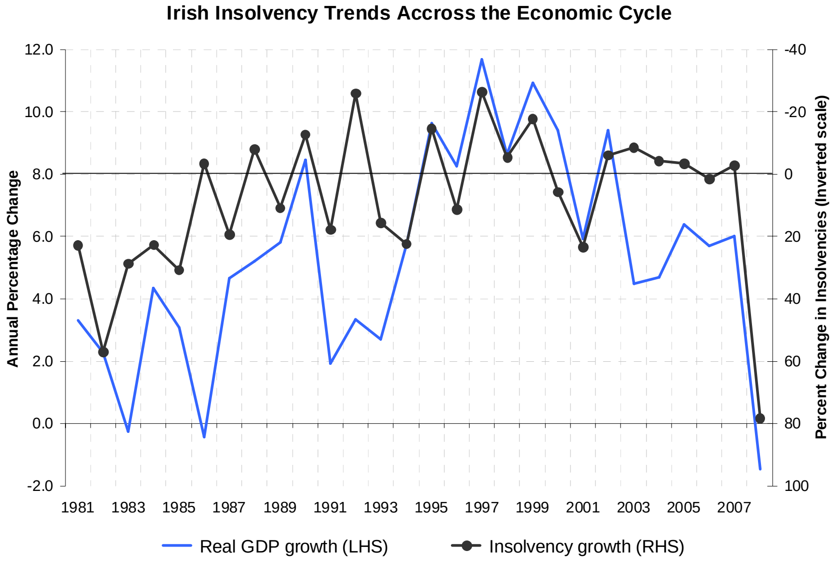
…and created a toxic mix in the financial sector



Sources: Global Insight, Atradius Economic Research.

- *There has been a symbiosis between financial sector growth and the construction industry.*
- *The growth of the financial sector has been unsustainably fast, with assets rising 125% in just six years, to stand at over 300% of GDP. This comes at a time when household savings have been falling, necessitating that banks tap financial markets to fund their expansion. Irelands loan-to-deposit ratio is 157%.*
- *Private sector credit growth within Ireland has been amongst the fastest of all industrialised countries, trending above 15% year on year for nearly two decades. Private sector credit surpassed 200% of GDP in 2007.*
- *A sizeable portion of new lending has been directed into the domestic mortgage market and construction (almost a third), as well as to private non-financial corporations. Banks have also internationalised the asset side, but the diversification benefit of expansion into the US and UK now looks limited.*
- *External money market funding lines have been withdrawn in recent months leaving the sector with a deepening funding gap that has had to be plugged by the government. Given the size of the sector, this now represents a huge contingent liability for the Irish sovereign.*
- *The government announced a recapitalisation plan on 21 December 2008, two months after moving to guarantee the deposits of banks. This amounted to €5.5bn into 3 banks – €2bn each into Allied Irish and Bank of Ireland and €1.5bn into Anglo Irish. This will be funded by the exchequer (€1.5bn) and the national pension fund (€4bn).*

Insolvency growth is now exploding…



Sources: Global Insight, the Companies Registration Office Ireland, Atradius Economic Research.

Note: 1. Real GDP growth rates are quarterly, year on year. Trend Irish GDP growth is calculated as a five year moving average. 2. Insolvency growth rates are calculated from annual data, expressed in year-on-year terms.

- *After two decades of rapid growth, Ireland has fallen into a recession that will be both deep and protracted.*
- *The economy will contract sharply on an annualised basis in 2009. Moreover, most estimates now suggest at least two years of negative growth (2009 and 2010).*
- *This marks the culmination of a two-decade long boom in Ireland, which has seen the economy move from being one of the poorest countries in Europe to becoming one of the richest on a per capita income basis.*
- *The recession is likely to be deep, and is already having an adverse impact on the corporate sector.*
- *Insolvencies rose by over 80% year-on-year during 2008, after having been remarkably stable in the preceding five year period.*
- *Empirical observation of insolvencies in other markets suggests that insolvencies increase steeply during recessions and that the growth in insolvencies is persistent. Given expectations of a deep and prolonged recession, we expect to see little let up in insolvency growth in coming years.*

…and recovery is a long way off

RECESSION IS UNDERWAY

- *Ireland faces a deep and protracted recession, caused by the bursting of a property price bubble and systemic financial crisis. Ireland is particularly susceptible given its dependence in recent years on construction, financial services and the property market to support growth. Furthermore, as much as 35% of all Irish exports are to the UK and US – the two markets where the contraction in economic activity is expected to be most severe.*

SOVEREIGN BALANCE SHEET UNDER PRESSURE

- *Although Ireland currently has low levels of public debt and has pursued prudent budget policy in recent years, its sovereign balance sheet is being severely tested. Tax revenues are being squeezed by the collapse of the housing market and assumed liabilities from the imploding financial sector are stacking up rapidly. The government has guaranteed all Irish bank deposits (equivalent to 200% of GDP), has nationalised Anglo-Irish Bank and will inject 5.5 billion euro of fresh capital into the sector. However, further recapitalisation, or outright nationalisation is likely and the costs of the bail-out will continue to escalate.*
- *There are increasing doubts as to the capacity of the Irish state to meet these obligations in the event of a banking collapse, since several of the Irish banks may be too big for the state to save. This fear is reflected in widening spreads on Irish government debt relative to German benchmark bonds. The budget deficit will rise to 9.5% of GDP in 2009 and the assumption of banking sector liabilities will likely force public debt significantly higher with attendant increases in debt service costs.*

RECOVERY PROSPECTS ARE CONSTRAINED

- *Public spending is being cut back sharply in order to absorb the costs incurred as a result of the bank sector bail out. Further fiscal retrenchment is likely. There is very limited room for a fiscal stimulus package.*
- *Membership of the Eurozone means that Ireland's economy cannot regain competitiveness through exchange rate depreciation. In other words, economic adjustment will have to come through falling wages and prices. Such adjustments, outside of the exchange framework, are painful and tend to be slow.*
- *Insolvencies will therefore continue to rise in the market for some time.*

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