Bank of Ireland
Global Markets

The Bulletin

Ireland in a European context

- Irish domestic spending fell more than the Euro norm
- Exports proved the exception

The Irish economy contracted by 7.1% in 2009, which was well below the euro zone average of 4.1%, but not the worst performance in the euro area or indeed the EU. Within the former, Finland recorded a 7.8% fall in GDP while across Europe as a whole the Baltic States contracted at more than double the Irish pace – Latvian output fell by 18%, Lithuania by 15% and Estonia recorded a 14% decline.

Last year's contraction in Ireland was steeper than the euro area for two main reasons. First, capital spending generally fell heavily across most developed economies and by 11% in the single currency area, but in Ireland the fall was some 30%, including a 34% fall in building and construction. This sector was also of more significance in the Irish economy than the norm elsewhere, but by the fourth quarter of 2009 had fallen to under 12% of GDP, or half its share of GDP at the peak of the construction boom. House-building alone now accounts for only 2.5% of real GDP, again dramatically lower than the 12% share in 2005.

Consumer spending also fell across the EU area, by 1.1% on average, reflecting falling employment and slower wage growth. In Ireland employment fell precipitously, by over 8%, and wages also fell on average, which partly explains why the fall in Irish real consumer spending, at 7.2% is unusually large, but Irish households also appear to have cut discretionary spending by more than the fall in disposable income. In other words the savings ratio went up, and may now be 11% - 12%, from under 3% in 2007.

The one area in which Ireland outperformed its European neighbours was in the external sector: Irish exports fell by 2.3% in volume terms in 2009, while exports in the euro area declined by over 13%. This implies Ireland gained market share which sits uneasily with the widely held perception that the economy has lost competitiveness in recent years. It is true that Irish hourly earnings in manufacturing have risen by 69% over the past decade, against a 39% rise in our main trading partners, but Irish productivity has also outpaced the competition, with the result that Irish unit labour costs in manufacturing have fallen 14% relative to our trading partners over the past decade, according to Central Bank data. This productivity growth has been largely driven by the multinational sector, however, so it would be more precise to say that the indigenous economy has lost competitiveness, but that the multinational sector has certainly not; the output of the multinational sector went up last year while indigenous production fell by over 14%. Multinational profits also rose last year; which also helps to explain why the income of Irish residents (GNP) fell by over 11% in 2009 and hence more precipitously than the output of the economy as a whole.

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United Kingdom

Bank of England on hold as inflation starts to drift back

Bank of England stays on hold...

The Bank of England kept its asset purchase scheme on hold and rates unchanged for its meeting in March. While the decision at the last meeting was "finely balanced" according to the February minutes, this decision was widely expected and it was unanimous. The minutes of March's meeting said there was "little evidence to suggest" that the economic outlook had materially changed. Although the MPC remain relatively unconcerned about the recent spike in inflation, the minutes did place somewhat more emphasis on the risks to inflation, saying that "If the economic recovery gathered momentum and upside pressures on inflation from energy prices and the exchange rate continued, there was a risk that the current period of above target inflation would be more prolonged. Some members considered that the upside risks to inflation had increased slightly over the month; others felt that the balance of risks had not changed materially" and that "It was increasingly likely that CPI inflation would remain well above the target over the months ahead. Against that background, there was a risk that the public's expectations of inflation over the medium term might begin to rise".

...as inflation falls to 3.0%...

UK CPI inflation slowed to an annual rate of 3.0% in February from 3.5% in January. The Bank of England's confidence that this is a temporary inflation blip may well be proved correct even sooner than expected, with the rate of inflation last month slightly lower than the consensus forecast. A better indicator of the inflation environment at the moment may be the CPI ex taxes measure which excludes the substantial impact of the recent increase in VAT - which will continue to impact on the overall annual rate all year. CPI inflation excluding indirect taxes fell further in February, to just 1.4%. The continuing fall in the ex indirect taxes rate does suggest that underlying inflation pressures in the economy are quite subdued. The MPC believes the recent spike in headline inflation is temporary and its forecasts show it falling back below 2% over the second half of this year.

...UK budget provides no insight into how deficits will be cut...

The UK budget was announced in late March and the planned budget deficits are slightly smaller than was flagged late last year. The deficit is estimated to be 11.8% of GDP in the fiscal year now ending (from an initial forecast of 12.6% of GDP) with the deficit cut to 4% of GDP by 2014/15. GDP growth is forecast at between 1 to 1½% this year, rising to 3 to 3½% next year and 3¼ to 3¾ in 2012. CPI inflation is forecast to be 2% this year, 1.5% next year then back to 2% in 2010. The Government reaffirmed its commitment to the 2% inflation target and to keeping in place the asset purchase facility for the next year. The Chancellor said he believed it was both wrong and dangerous to heed calls to cut spending immediately as such cuts would risk the recovery. The Treasury now expects to get more tax revenue and spend less than it forecast at the end of last year, but there is not huge differences in this week's budget just slight improvements. The UK Government has provided no solid plans about how it intends to cut the deficit level. The budget was very much a holding exercise, with the real problems of how to sort out the public finances in the medium term left to whoever wins the summer election.

...while election uncertainty causes sterling to fall.

The euro gained sharply on sterling in the last week of February and the first week of March. Sterling fell from around £0.875 to the single currency to around £0.91 in mid March. The main catalyst for this fall appears to be increasing political uncertainty about the shape of the next parliament. The opinion polls indicate that the general election (widely expected on May 6th) will return a hung parliament with the Conservatives as the largest party but without a working majority. An unstable Government would likely struggle to reign in the public finance deficit. Sterling made something of a comeback late on in the month, returning to below £0.90 as the euro struggled in light of the situation involving Greece. Against the dollar, sterling fell from over $1.55 in late February to around $1.48, and ended the month at close to $1.51.

Europe

Greece saga rumbles along

Greece aid finally agreed but IMF will be involved...

The issues surrounding Greece have been very much to the forefront over the past month. In mid March, it looked like the EU was finally getting its act together and would give Greece a more concrete promise of aid. Finance ministers agreed that the aid (if required) would come through Governments pooling funds to extend loans to the country and the ministers' statement said "The objective would not be to provide financing at average euro-zone interest rates, but to safeguard financial stability in the euro area as a whole". However, less than a week after that promised agreement, the German Government decided that they wished for the IMF to be involved in any aid package for Greece. This caused a rift among the large European partners as French President, Sarkozy, as well as ECB President Trichet, were against any IMF involvement; presumably because it would indicate that the EU is incapable of solving its own internal problems. At the end of March, after many days of confusion, Euro area leaders finally agreed the form of an aid package for Greece, though they were quick to point out that the Greek government has not requested any financial support and said that any aid would only be triggered in the event that "market financing (for Greece) is insufficient". As part of a package that would also involve "substantial" IMF financing but a "majority" of European financing, Euro area member states "are ready to contribute to coordinated bilateral loans" to Greece. Any disbursement of the bilateral loans would be decided by the euro area member states by unanimity "subject to strong conditionality and based on an assessment by the European Commission and the European Central Bank". According to the leaders' statement, the objective of any financial help "would not be to provide financing at average euro area interest rates, but to set incentives to return to market financing as soon as possible".

...Euro falls against the dollar as US economy outperforms...

The crisis over problems in Greece has pushed down on the euro over the past month. Against the dollar, the euro had fallen to about $1.35 by the end of March from $1.38 in mid-month and from around $1.45 in January. The concerns over the public finances in some member states is pushing down on the euro but the dollar is also being boosted by the increasing probability that the Federal Reserve will start to increase interest rates before the ECB. The US recovery is far stronger than the EA recovery at the moment; the latest available data shows that the US economy expanded by 1.4% in Q4 of last year, while the Euro Area economy is estimated to have expanded by just 0.1% in the same period. 2-year bund yields have fallen from over 1.3% at the start of the year to under 1% by end month, while at the same time US 2-year treasury yields are largely unchanged, falling from about 1.1% to around 1.05%. Officials from the US central bank have spoken about their exit strategy from the current accommodative policies and have started the ball rolling, as such, by increasing the interest rate charged in the discount window. While actual increases in the main fed funds rate is still some way off, we believe they are likely to start tightening by the end of this year. The ECB is somewhat behind this curve and we do not see interest rate increases in the Euro area until the second quarter of 2011. All of these factors add up to dollar strengthening against the euro, and we are probably seeing the proof in the exchange rate movements over the past few weeks and months.

...but EA recovery may still be on track after revised data.

In addition to underperforming the US economy, data at the start of the year has indicated that the economic recovery in the Euro area may be softening. However, some substantial revisions to data have indicated those concerns may be somewhat overdone. Euro area industrial production rose by 1.7% in January, the biggest jump in one month since Euro area data was first compiled in 1990. Production in December was also revised dramatically upwards, from an initially reported fall of 1.7% to an increase of 0.6%. Euro area production appears to be gaining strongly heading into the first quarter of this year. Due to that initially reported fall in production in December, economists had feared that the euro area recovery was slowing; however the revised data changes the whole complexity of the situation and indicates that the manufacturing sector is continuing a strong recovery. Industrial production rose by 0.7% per month on average in the 4th quarter, up from a 0.5% average in the 3rd quarter. This also has implications for 4th quarter GDP growth which was estimated at 0.1% last month but may now be revised slightly.

United States

Fed retains "extended period" language

Fed retains "extended period" language...

The Fed cut its key interest rate to a range of 0% to 0.25% back in December 2008 and noted then that "economic conditions are likely to warrant exceptionally low levels of the federal funds rate for some time". In March 2008 the Fed tweaked its language a little, noting that exceptionally low levels of interest rates are likely to be warranted for an "extended period". It has retained the "extended period" language at every meeting since, including at its last meeting on March 16th, notwithstanding some market chatter that it might amend this particular wording.

The economy has improved a good deal since late 2008/early 2009, of course. Measured in terms of GDP, the recession ended in the second quarter of 2009, and the economy expanded quite strongly over the second half of the year with output rising by 1.4% - or at an annual rate of 5.7% - in Q4. The recovery has continued into 2010, as the Fed noted in the statement published after its March meeting, with consumer spending and business investment both rising further in the opening months of the year.

...as inflation pressures subdued...

The recession was relatively deep, however, with output falling by almost 4% from peak to trough. Even with the recent recovery, output is still about 2% below its level prior to the onset of the recession and even further below where it would have been if the downturn hadn't happened. As a result, the degree of spare capacity in the economy is large – as evidenced by an unemployment rate of around 10%, almost double its long-run average – and inflationary pressures are subdued; the core CPI rose at an annualised rate of just 0.1% in the three months to February 2010, a deceleration from the 1.5% increase over the previous six months. It will take some time for this spare capacity to be eroded, and for inflationary pressures to emerge, hence the Fed *still* believes that "economic conditions...are likely to warrant exceptionally low levels of the federal funds rate for an extended period".

...though market expects rate hike later this year...

As economic and financial conditions have improved, though, the Fed has withdrawn most of its emergency liquidity support to the markets. All bar one of the special lending facilities set up in the midst of the recession have now expired, while the Fed has twice raised its discount rate, the rate it charges banks to borrow from it overnight. It has also completed its (MBS) asset purchase programme. Though the Fed has emphasised that none of these developments signal an *imminent* change (i.e. tightening) in its monetary policy stance, they can be seen as the first moves in a process that will see the federal funds rate *eventually* move higher. The market currently expects the Fed to start raising interest rates by the end of this year.

...and bond yields have risen further.

We have noted previously the steady rise in government (Treasury) bond yields since late last year, which has been in response to the improvement in economic conditions. Yields continued to rise through March, by about 25bps in the case of 2- and 10-year yields to around 1.05% and 3.85% respectively. That said, yields are still within the ranges that have prevailed for the best part of a year now, though a test of the topside of these ranges, which is about 15bps (10-year) to 35bps (2-year) above current levels, is possible in the period ahead. Yields have also increased further *relative* to their euro equivalents, as the US economy has outperformed the euro area economy. In the case of 2-year yields, for example, the increase has been about 20bps since the end of February, bringing the swing since last November - when US yields were trading about 60bps *below* euro yields - to almost 75bps. Rising US yields have contributed to some further strengthening of the dollar against the euro over the past month. As US yields rise further, we expect the dollar to strengthen further over the coming months.

Swap Rates

New cycle lows in Europe

Euro swap rates fell to new cycle lows in March: 5-year rates traded around 2.40% and 2-year rates hit 1.45% before rising marginally to around 1.5%. This move reflects a much more dovish market outlook on the likely path of ECB rates, with monetary policy expected to remain very loose for some time. 3-month cash, for example, which is currently just under 0.6% is not expected to rise to 1% (the current ECB repo rate) until the end of the year with the first tightening move not fully priced in until the second quarter of 2011.

The market is more dovish on the European rate outlook...

This change reflects a number of factors. First, the economic recovery in the euro area has been modest to date, with GDP rising by just 0.5% in the second half of 2009, leaving output almost 5% below its peak. Moreover, the first quarter GDP data is unlikely to be very strong, given the adverse weather in Western Europe. Second, the ECB is not convinced about the robustness of the recovery, with a 'bumpy road' seen as the likely path. Moreover the ECB expects inflation next year to emerge well below the 2% target given the degree of spare capacity. Third, the repo rate is currently ineffective anyway as short term cash rates are well below 1% and the ECB will spend the next six months seeking to bring rates back up to the repo level by draining liquidity from the system. Consequently, euro swap rates are unlikely to rise sharply this year and we expect the 5-year to trade in a range below 2.75%.

Sterling rates have also hit new lows, with the 5-year below 3%, again reflecting a much more benign outlook for UK monetary policy. The MPC still believes that inflation, which is currently at 3%, has been pushed up by temporary factors and that it will fall below the 2% target this year and remain there for some time. We suspect the MPC will raise rates earlier than the ECB, albeit not this year, but swap rates in sterling may rise in the second half of 2010, in anticipation of such a move.

...but dollar swap rates are rising.

Finally in dollars the picture is different, in that rates have moved higher in recent months from lows in early December with the 5-year around 2.75%. Longer term interest rates have begun to move higher in response to better economic data, with consensus forecasts for US GDP growth now moving up to 3% and above. We expect swap rates to continue to rise, particularly if employment starts to pick up, although one should also note that at certain maturities swap rates are trading below government bond yields i.e. investors would prefer to receive a fixed payment from a bank rather than the Federal government. This suggests a high degree of distortion in the swaps market, and therefore the prospect of a high degree of volatility as this unusual development unwinds.

	Euro		Sterling		Dollar	
	End-June	End-Sept	End-June	End-Sept	End-June	End-Sept
2-year	1.50	1.60	1.70	2.00	1.50	1.75
5-year	2.50	2.60	3.00	3.25	3.25	3.50
10-year	3.35	3.45	4.00	4.20	4.20	4.35

Economic Diary

April

	Euro Area	UK	US
1	PMI Manufacturing, German Retail Sales	PMI Manufacturing	ISM Manufacturing
2			Non-farm Payrolls, Unemployment
5			ISM Non Manufacturing, Pending Home Sales
6			Minutes of the FOMC
7	PMI Services, GDP, German Factory Orders	Consumer Confidence, PMI Services	
8	ECB Meeting, Retail Sales, German Industrial Production	BoE Meeting, Industrial Production	
9		PPI's	
14	Industrial Production		Inflation Data, Retail Sales, Beige Book
15			Industrial Production, Philly Fed
16	Inflation Data		Housing Starts, Uni of Michigan Confidence
19		Rightmove House Prices	
20	ZEW Surveys	Inflation data	
21	PMI Surveys	BoE Minutes, Unemployment data	PPI's
22	Consumer Confidence, German PMI's	GDP, Retail Sales	Existing Home Sales, House Prices
23	Industrial New Orders		Durable Goods, New Home Sales
26		Nationwide House Prices	
27			S&P Case Shiller Home Prices

Forecasts

Bank of Ireland estimates

Exchange Rates

	Current	End Jun	End Sep	End Dec
EUR/USD	1.35	1.30	1.30	1.30
EUR/GBP	0.89	0.85	0.83	0.80
USD/JPY	93.4	100	100	100
GBP/USD	1.52	1.53	1.57	1.62

Source: Bank of Ireland Global Markets

Official interest rates

	Current	End Jun	End Sep	End Dec
USD	0-0.25	0-0.25	0-0.25	0.75
EUR	1.00	1.00	1.00	1.00
GBP	0.50	0.50	0.50	0.50

Source: Bank of Ireland Global Markets

Swap rates: 5 year

	Current	End Jun	End Sep	End Dec
US	2.75	3.25	3.50	3.75
Eurozone	2.40	2.50	2.60	2.75
UK	2.85	3.05	3.25	3.50

Source: Bank of Ireland Global Markets

GDP and inflation (annual average)

	2010		2011	
	GDP	Inflation	GDP	Inflation
US	3.0	2.0	3.0	1.9
Eurozone	1.1	1.2	1.5	1.5
UK	1.2	2.5	2.5	1.7

Source: Bank of Ireland Global Markets

Bank of Ireland Global Markets

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