



# The Bulletin

A monthly analysis of international and Irish markets

## Central banks' rates to stay low

- ECB may not raise rates until next year
- UK rates also unchanged in 2010

The IMF recently revised up its global growth forecast (not for the first time) for this year and next and now expects the world economy to expand by 3.9% in 2010, followed by 4.3% in 2011. The projected expansion is heavily skewed towards the emerging economies, however, notably Asia, and within the advanced economies there is also a pronounced dichotomy, this time between the US and Europe.

The US economy picked up momentum in the latter part of 2009, growing by 1.4% in the final quarter, and the most recent data implies a strong start to 2010, with the result that the consensus GDP forecast for the year as a whole has moved higher and now stands at 3%. In contrast, the euro economy lost momentum in the final months of last year - Italy contracted and German growth was flat - leaving GDP growth in the fourth quarter at just 0.1%. Moreover, the most recent data points to a weak first quarter exacerbated by adverse weather, and the consensus growth forecast for 2010, currently 1.2%, may well be revised down.

The most recent data on the UK economy has also tended to surprise to the downside, although again the January figures were no doubt hit by the weather. The Bank of England has also become less optimistic on the UK growth outlook, and has revised down its growth projections for this year and next.

These developments in the relative growth outlook have already influenced the FX markets, boosting the dollar, and interest rate expectations are also changing. Specifically, it now looks less likely that the ECB will raise rates this year, given the anaemic growth outlook for Europe and the implication that inflation will stay low, and we now expect the repo rate to stay at the current level until the first half of 2011. Nothing is certain, of course, but the ECB is likely to spend the rest of the year draining cash from the system in order to bring money market rates up to the repo level - short term rates are currently well below the 1% repo rate, so any move in the latter would be ineffective anyway until the monetary overhang is addressed.

The picture is less clear cut in the UK, as inflation is currently well above the 2% target and the unemployment rate appears to have stabilised, but the Bank of England feels that inflation will fall back and remain at low levels given the amount of spare capacity in the economy. Consequently, we now expect the first rate rise in the UK to emerge in the spring of 2011. For the US however, we still feel that rates will still start to rise this year, albeit in the autumn at the earliest.

Dr Dan McLaughlin

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**United Kingdom**

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## Bank of England on hold for now

**Bank of England pauses asset purchases at their February meeting...**

The Bank of England (BOE) left interest rates unchanged, at 0.5%, at the MPC meeting at the start of the month and also decided to maintain the stock of asset purchases under its QE program at Stg200bn. The BOE did leave open the option that they might resume purchases of assets, if that proves necessary, in the future. The BOE said it expects only a “gradual recovery in the level of economic activity” and for inflation to eventually “fall back below target for a period”. It noted that the “stock of past asset purchases and the low level of the Bank Rate would continue to impart a substantial monetary stimulus to the economy for some time to come” and therefore it was appropriate to maintain its stock of asset purchases at Stg200bn. However, it said “further purchases would be made should the outlook warrant them”.

**...but the minutes reveal the decision was “finely balanced”...**

The minutes of the MPC revealed members voted 9-0 to keep rates on hold and paused the asset purchase scheme. They felt economic activity was recovering weakly but the medium term economic headwinds remained considerable. The arguments for and against extending the QE program were “very finely balanced” for some members. The case for extending monetary stimulus was due to the projections in the inflation report that inflation was more likely than not to be below target for much of the next three years. Against this, members argued there was little merit in attempting to fine tune the inflation projection given the degree of uncertainty about the future. The MPC was also concerned about raising QE at a time when inflation was substantially above target and the risk that expanding the size of the purchase program could add to inflation expectations. Some also feared that further purchases could push up asset prices. Finally, maintaining the current level of monetary stimulus would allow the committee an opportunity to judge more thoroughly the effects of the cumulative loosening of monetary policy that it had implemented since September 2008. The stock of past purchases will continue to provide stimulus into the economy for some time yet. While the door is left open to further asset purchases, the overlying message from the MPC is that it is becoming more and more likely we will not see any increase in the base rate until 2011.

**...however the inflation report presented a more dovish view...**

In its February Quarterly Inflation Report the BoE revised down the outlook for both inflation and growth from the forecasts in the November report. Over the forecast horizon, the Bank now expect inflation to be below target in 2 years if rates are left unchanged at 0.5% and the asset purchase scheme was left at £200bn. King said that “Spare capacity will press down on inflation in the medium term. It is more likely than not that inflation will be below target for much of the forecast period, but the risks are broadly balanced by the end.” The report indicates that the MPC will be in no hurry to raise interest rates this year. They forecast that inflation would be around 1.2% in two years time if the MPC were to increase the base rate in line with market expectations. GDP growth rates were also revised downwards compared to November’s report. However, the rate of growth in 2011 and 2012 is still expected to be above the long term average for the economy. The report said that “while most likely path for growth is somewhat weaker, some of the downside risks are smaller than in November.”

**...although inflation is currently over 3%.**

CPI in the UK rose to an annual rate of 3.5% in January from 2.9% in December. As the rate was over one percentage point away from the 2% target it triggered, as is usual, a letter of explanation. As explained in the letter, the MPC believe that the current rise in inflation will be temporary. Short term factors including the restoration of the 17.5% VAT rate has pushed up inflation recently. However, the MPC believes the weakness in spending, which has created a substantial margin of spare capacity in the economy, will bear down on inflation pressures over time. The MPC is having a tough time communicating their strategy at the moment. It’s difficult to explain a “dovish” outlook when inflation is currently a full 1.5% above target. However, if one looks at the annual CPI rate ex indirect taxes the picture becomes clearer. The ex indirect tax annual CPI rate has fallen from 3.0% in November to 1.9% in January. That index has not been below that target since 2007 but is expected to be below target in the medium term. It could be argued that the MPC’s thinking is based along analysis of a rate such as this. It excludes much of the base effects which are negatively affecting the headline rate and could be more reflective of the underlying inflationary conditions in the economy.

## Europe

## Euro declines over Greek Tragedy

### Greece dominates the headlines...

The news about the Euro area this month has been dominated by the public finance problems in Greece which has spilled over as the markets become concerned about other peripheral countries. This has coincided with a continuing decline of the Euro against the Dollar. However, of more concern may be the worrying signs of slowdown in the recovery in some of the Euro area's larger members, namely Germany.

### ...as Euro Area has to consider a fiscal aid plan...

Starting with the situation in Greece, this story has been rumbling along for many weeks now but we did have some major developments this month in the saga. The size of the Greek deficit this year (about 12%) is worrying and it is compounded by the current size of the national debt already (estimated to be about 110% of GDP) and scepticism that the Greeks have a viable plan to reduce their deficit. These concerns are weighing down on the Euro Area as a whole. This prompted EU leaders at an emergency summit to say they fully supported the efforts of Greece to reduce its budget deficit in 2010 and over the following years and called on it to implement measures in a "rigorous and determined manner". They also said they would "take determined and coordinated action, if needed, to safeguard financial stability in the euro area as a whole". However, this pledge to provide financial support to Greece if necessary (although the Greek government said that it did not request any financial support) was not backed up by any concrete details regarding what shape or form that support might take. That meeting took place in the middle of the month but it is still not clear exactly what support the Euro Area intends to offer Greece if any financial support at all. However, the Euro Area Finance Ministers warned the Greek government that it has until the middle of March to demonstrate it is taking adequate steps to reduce the budget deficit by four percentage points of GDP as planned or additional measures will have to be implemented. Greek bonds yields have fluctuated widely over the past month as the markets tries to make sense of the situation in Greece; 10 year yields ranged from over 7% at the end of last month to under 6% around the time of the EU summit. They were back at over 6.5% towards the end of month with little clarity about whether there is an EU rescue plan or not. Domestically in Greece, the planned austerity measures are being strongly resisted by the public and it's difficult to see how they can implement stringent deficit cutting plans in the short term. The concerns over Greece is putting pressure on other southern European nations – Portugal, Spain and Italy – as markets fear others will need Euro Area financial aid should Greece falter and need a bailout.

### ... and German economy wobbles while Euro continues decline...

What is of equal concern are worrying signs that the German recovery is hitting a rough patch. Growth in Q4 was flat with private consumption falling 1.0%, government spending down 0.6% and investment dropping 0.7% with the saving grace being, as usual, exports which gained 3.0%. There are signs that this quarter is not going to be much better. Industrial production fell fairly sharply in December - down 2.6% - so January is not going to benefit from strong momentum in that sector. The PMI manufacturing held up well in February rising to 57.2 but PMI services fell to 51.7 from 52.2 a month earlier. The ZEW index of investor sentiment also declined in the month and the IFO indices also fell. The hard and soft data are now showing that conditions across most sectors remain weak in Germany. That, of course, has wider implications for growth in the Euro area as a whole. While the losses that the Euro has sustained over the past few weeks and months is undoubtedly caused to a large extent by the ongoing debate about public finance stability amongst Euro members, it is also probably in part due to the poor economic picture that is emerging in Germany. The data does not suggest that the economy is going to slip back into recession but the recovery is probably hitting a bumpy patch in the road. The Euro's decline against the dollar continues as the US economy delivers a robust recovery in contrast to the Euro area. The Euro is down to about \$1.36 at the end of February from around \$1.40 at the end of January. We think the Euro is set for further losses this year. We now think the economic situation will mean that the ECB will not raise the main refinancing rate until the first quarter of 2011 while the Federal Reserve will start their tightening cycle in late Q3 or early Q4 2010 as the American economy strengthens.

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**United States**

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## Fed in no hurry to exit accommodative policy

### **Economy ends 2009 on a strong note...**

The US economy emerged from recession in the third quarter of 2009, having contracted in each of the four previous quarters, with GDP rising by 0.6% (or 2.2% at an annual rate). The pace of growth accelerated in the final three months of the year, with GDP increasing by 1.4% (5.9% at an annual rate). While a slower pace of “de-stocking” by businesses accounted for just over half of the increase in GDP in Q4, the growth in final demand (GDP *less* inventories) accelerated further – to 0.6% from 0.2% in Q3 – with consumer spending, business spending (on equipment and software) and spending on residential construction all rising again over this period.

### **...and makes positive start to 2010...**

The economy has made a positive start to 2010, judging by the available indicator data, and GDP looks set to rise further in the first quarter, though perhaps not at the same pace as in Q4 (the consensus forecast is for an increase of 0.8%). Retail sales rose by 0.5% in January to leave spending running about 1% above its level in Q4, while new housing starts rebounded in the same month to leave them running some 6% above Q4 levels. Capital goods orders also remain on an upward trend, pointing to a further increase in business investment. Consistent with these indications of rising demand in the economy, industrial output rose further in January – by almost 1% from the previous month – and is now almost 6% off its trough in June 2009. Moreover, the “soft” data, notably the closely followed ISM manufacturing survey, suggest that output is set to increase further in the coming months. The production and orders components of the ISM survey rose in January to 66.2 and 65.9 respectively – a six-year high in each case – to leave both running way above the expansion-contraction threshold of 50.

### **...but labour market still weak...**

The resumption of economic growth has not yet translated into an increase in employment. This is not too surprising, as there is normally a lag between economic activity rebounding and employment recovering. That said, employment was unusually slow to recover following the end of the last two recessions in the early 2000s and early 1990s, and there is concern that it may be similar this time round as well. The pace of decline in employment has slowed substantially however, to just 35k a month in the three months to this January from about 500k a month in the second quarter of 2009, just before the economy emerged from the downturn. The unemployment rate has actually declined a little recently, to 9.7% in January from 10.1% in October, though this has been due largely to a further decline in the labour force participation rate over this period. The latter may reflect the fact that some people may have become discouraged from looking for work and hence are no longer classified as unemployed. As the recovery proceeds, however, people might be tempted to return to the labour force and hence, ironically, the unemployment rate might spike higher again before it starts to head lower on a sustained basis. All of that said though, most of the rise in the unemployment rate is now in the past.

### **...so Fed won't raise interest rates for some time.**

In any case, the Fed believes the current unemployment rate is considerably above the rate consistent with “full employment”, which it considers to be in the vicinity of 5-6%. It also believes that it will take some time before the economy returns to full employment, even though it expects reasonably robust GDP growth over the next couple of years – it sees GDP increasing by 3.25% in the year to Q4 2010 and by 4% over the following 12 months. Hence the Fed expects this “substantial margin” of unused resources to bear down on costs and prices in the economy and therefore for inflation to remain “subdued for some time”. According to its latest projections, inflation is expected to remain between 1 and 2 percent in 2010 through to 2012. On account of this, in turn, the Fed continues to insist that “economic conditions...are likely to warrant exceptionally low levels of the federal funds rate for an extended period”, a message reiterated by the Fed Chairman, Ben Bernanke, in his semi-annual testimony to Congress on the economy and monetary policy in late February.

Yields on US government bonds have risen further since the end of January, with the largest increases occurring at the longer end of the maturity spectrum. However, the absolute rise in yields from their end-January levels has been modest enough – at most 10bps – and yields are still well off their highs in 2010 to date set back in early January following a sharp rise over the previous couple of months or so. Meanwhile, swap rates are actually unchanged to slightly lower from the end of January and are also well off their early January highs. It would seem that, notwithstanding the pick-up in economic activity, markets have listened to what the Fed has said and, accordingly, have scaled back the extent of any Fed policy tightening this year, hence the fall in market interest rates from their recent highs.

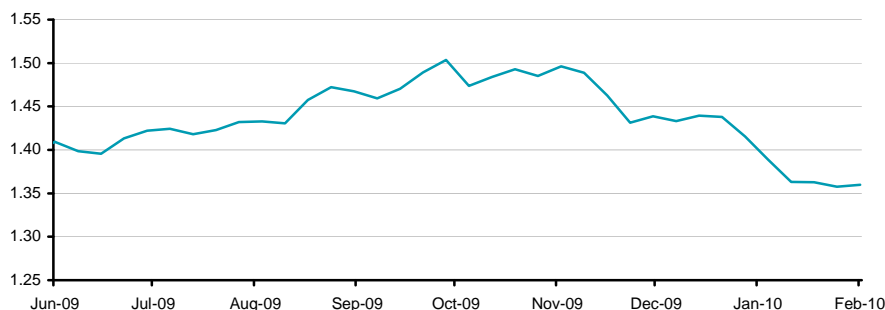
**Dollar makes further gains...**

US yields have, though, risen further *relative* to their euro equivalents since the end of January. The spread, or differential, between US and German 10-year yields, for example, has widened out by a further 15bps over this period and now stands at around 55bps. The latter is about 50bps wider than at the end of November – i.e. US yields have risen by 50bps relative to the euro equivalents - and is related to the obvious out-performance of the US economy relative to that of the euro area economy over this period. As we noted in our last bulletin, we think this rise in US yields also goes some way towards explaining the rise in the value of the dollar against the euro since the end of November, with the US currency having strengthened from around \$1.51 to \$1.35, or by almost 12%, over this period. Of course, other factors specific to the euro, most obviously the concerns that have arisen because of the fiscal difficulties facing Greece, have weighed on the single currency as well.

**...with more to come.**

The euro-dollar rate has already reached our end-March target of \$1.35, having fallen from around \$1.39 at the end of January. We are not changing our end-March target but we still do expect the dollar to strengthen further to \$1.30 over the coming months, as the US economy continues to run ahead of its euro area counterpart.

**EUR/\$ Exchange Rate**



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**Economic Diary**


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**March**

	<b>Euro Area</b>	<b>United Kingdom</b>	<b>United States</b>
1	PMI Manufacturing, Unemployment data	Mortgage Approvals, M4 money supply, PMI Manufacturing	Personal Income and Spending, ISM Manufacturing
2	Flash HICP estimate, PPI's		
3	PMI Services, Retail Sales	PMI Services, Consumer Confidence	ADP Employment, ISM Non Manufacturing, Fed Beige Book
4	4Q GDP data, ECB Meeting	BOE MPC meeting	Factory Orders, Pending Home Sales
5	German Factory Orders	PPI's	Non farm payrolls, Unemployment
8	German retail sales and Industrial production		
9		RICS House Price Balance	
10		Industrial Production	
12	Industrial Production		Advance Retail Sales, Uni. of Michigan Confidence
15	Employment data	Rightmove House Prices	Industrial Production
16	Inflation data, Zew Surveys		Housing Starts, FOMC meeting
17		Bank of England Minutes, Unemployment data	PPI's
18			Inflation data, Philly Fed, Leading indicators
22	Consumer Confidence		
23		Inflation data,	Existing Home Sales
24	Industrial New Orders, German IFO's		Durable Goods Orders, New Home Sales
25		Retail Sales	

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## Forecasts

## Bank of Ireland estimates

## Exchange Rates

	Current	End Mar	End Jun	End Sep
EUR/USD	1.36	1.35	1.30	1.30
EUR/GBP	0.91	0.85	0.83	0.80
USD/JPY	89	95	100	100
GBP/USD	1.50	1.59	1.57	1.63

Source: Bank of Ireland Global Markets

## Official interest rates

	Current	End Mar	End Jun	End Sep
USD	0-0.25	0-0.25	0-0.25	0-0.25
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 Mar	End Jun	End Sep
US	2.60	2.75	3.25	3.50
Eurozone	2.50	2.50	2.75	3.00
UK	2.95	3.00	3.25	3.75

Source: Bank of Ireland Global Markets

## GDP and inflation (annual average)

	2010		2011	
	GDP	Inflation	GDP	Inflation
US	2.70	2.1	2.90	2.1
Eurozone	1.20	1.3	1.50	1.4
UK	1.2	2.5	2.5	1.7

Source: Bank of Ireland Global Markets

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Market data supplied by Reuters

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