Produced by the Economic Research Unit
July 2010

Bank of Ireland
Global Markets

TheBulletin

A monthly analysis of international and Irish markets

Fiscal consolidation in the UK

- New government announces significant deficit reduction
- Sterling strengthens further

Fiscal consolidation is now occurring in many countries, as governments attempt to bring down budget deficits that have risen sharply over the past couple of years. In the case of some countries, for example Greece, Spain and Portugal, this austerity has been forced upon them by the markets. In the case of others, like the UK and Germany, governments have voluntarily decided to reduce deficits, albeit the process will not begin in the latter until 2011. Interestingly, the US government argues that securing a sustainable economic recovery is the priority and so will complete its existing 'stimulus' programme before turning its attention to deficit reduction.

The new UK government plans an aggressive fiscal consolidation over the medium-term, with the budget deficit projected to fall from 11% of GDP in the fiscal year 2009/10 to just over 1% in 2015/16. Though the economy is still in the very early stages of recovery, the government intends to cut the deficit by 3.5% of GDP by the end of the fiscal year 2011/12. This is likely to have some dampening effect on economic activity over this period, and indeed the newly created Office for Budget Responsibility (OBR) has revised down its forecast for GDP growth in 2010 (marginally, to 1.2% from 1.3%) and 2011 (to 2.3% from 2.6%) after incorporating the measures announced in the budget.

Fiscal consolidation will also add to the Bank of England's monetary policy dilemma. Notwithstanding the depth of the recent downturn, inflation remains well above the target of 2%. The resilience of inflation has already prompted one member of the MPC to vote for an increase in interest rates. The planned increase in VAT from January next year means, everything else equal, that inflation will be slower to return to target than the MPC had previously thought. If this causes *expectations* of inflation over the medium-term to rise, the MPC has indicated it might have to respond by *raising* interest rates. However, it is likely that the MPC will have to revise down its forecasts for GDP growth in light of the planned fiscal consolidation. It has also indicated that a significantly weaker outlook for economic growth on account of deficit reduction might have to be met by an *easing* of monetary policy, presumably through an extension of its asset purchases programme (QE) given that interest rates are already close to zero.

The most likely outcome in our view is that monetary policy remains on hold, with interest rates staying at 0.5% until well into 2011 and no extension of QE. What of the implications for sterling of the planned fiscal consolidation? The combination of very low interest rates and a significant tightening of fiscal policy might be expected to weaken a currency. However, sterling strengthened against both the euro and the dollar post the budget. The market obviously views the proposed deficit reduction as credible. It also seems to believe it secures the UK's top sovereign rating. Further gains probably lie ahead for currency, with a move to 80p and perhaps below against the euro now likely.

Michael Crowley

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United Kingdom

Fiscal consolidation underway; MPC splits with Sentance voting for rate hike

Osbourne plans should have a negative effect on UK growth...

The UK budget fulfilled expectations of swift fiscal consolidation and Chancellor Osbourne committed the new administration to implementing austerity measures that should reduce the current budget deficit to zero by 2015 from about 10% this year and reduce the net borrowing requirement from about £150bn this year to about £20bn in 2015. Crucially, the deficit is expected to be about 2.1% by 2014, which is well below the Maastricht reference level of 3%, and should ease any lingering rating downgrade concerns. Amongst the policy changes is a VAT increase– which will add approximately 0.6% to CPI in a full year – but that won't kick in until next year with both Chancellor Osbourne and Governor King hoping that inflation will be a good deal lower at that stage. Of course, the base effect from last January's 2.5% VAT increase is due to drop out at that point so the net effect will be no change in the contribution the increased VAT rate is having at the moment. The CGT rate is to be increased and tax allowances frozen. Corporation tax is to be progressively cut over the next number of years to 24% which would leave the corporation tax rate amongst the lowest in the G20. A bank levy is to be introduced on domestic banks and foreign banks' UK operations. On the spending side, benefits are to be linked to CPI rather than RPI, child benefit will be frozen and there are cuts to social welfare allowances. Most public service pay will be frozen for 2 years and there is a full spending review which will see all Government departments' real budgets cut by about 25% over the next 4 years. The new GDP growth forecasts are revised down to 1.2% this year and 2.3% next year; next year's forecast is about 0.3% lower than the OBR early June forecast and close to a full percentage point lower than the last budget's forecast. The new forecasts do not envisage GDP growth above 3% any year to 2015. Inflation is forecast to fall to 2.4% in 2011 from 2.7% this year and return to target after that. The Government's fiscal consolidation measures will mean that the government contribution to growth will average minus 0.5% annually over the next 5 years. The Debt Management Office said it will issue £165bn in bonds this year, just over £20bn down on what they had said would be issued under the last budget. The markets have welcomed the budget and Sterling gained on the Euro and the Dollar in the weeks after it was announced, up to £0.82 from £0.8350 and $1.49 from $1.47 respectively. Gilts also gained, with 10 year yields down about 20bps by the end of the month compared to the week before the budget statement

…but Sentance still sees need for immediate rate hike.

The minutes of the June MPC meeting threw up something of a surprise. We had expected some level of dissent from Andrew Sentance after his recent speech questioning the inflation environment. However, in the end, he voted for a 25bps increase in a 7-1 split which kept the base rate at 0.5%. The committee voted unanimously to keep the QE program limit at £200bn. This is the first split decision since February 2009 and the first vote for a base rate increase since August 2008. The minutes said that, for one member, inflation had proved resilient in the aftermath of the recession, casting doubt on the future dampening impact of spare capacity on inflation. Demand had recovered at home and abroad, and despite current uncertainties, for this member, it was appropriate to begin to withdraw gradually some of the exceptional monetary stimulus. On the flip side, other members thought the balance of risks were insufficient to warrant a change in monetary policy. For them, the evidence from indicators supported the view that the current policy stance was appropriate and that there was further uncertainty (at the time of the meeting) over the nature and scope of the fiscal measures to be announced in the Budget. On inflation, the minutes noted that, while it remained likely the inflation would moderate in 2010 the outlook in the medium term would depend materially upon the evolution of inflation expectations. The most recent survey readings indicated that expectations for inflation one and two years ahead had risen markedly to their highest since 2008. It was likely that these expectations measures had been influenced by the recent outturns for inflation itself. In summing up, the MPC saw two risks to the outlook for inflation: (i) that external demand would be dampened by the debt crisis in Europe and (ii) that inflation would have a further tendency to remain above the target if the private sector's expectations of inflation over the medium term also rose. However, the committee's central view remains that the substantial margin of spare capacity is likely to persist for some time and will bear down on inflation into the medium term. There is no evidence in the minutes that there is any backing of Sentence's views by other members. He is likely to be a lone voice for some time, with nothing to suggest there is enough concern amongst the other members to make a hike a possibility in the short term.

Europe

Euro area recovery to slow in 2011

Euro may be settling into tight range vs Dollar…

After hitting a low of $1.19 to the Dollar in the early part of June, the Euro has picked up somewhat since then. It has been helped by some weaker than expected US data which indicates that the US recovery is proceeding but may not be as robust as previously thought. The single currency has got up to around $1.24 at times but has failed to consistently break through that level. It settled into a relatively tight range of $1.22 and $1.24 over the last couple of weeks of the month. The Euro is likely to remain under pressure in the medium term and we think it could stay around $1.20 to $1.25 for the next couple of months at least. The economic data from Europe is consistent with the view that the recovery should strengthen through the middle quarters of the year before weakening public and private demand due to austerity measures starts to impact at the end of this year/start of next year, causing the pace of the recovery to slow. The fiscal consolidation measures needed in EA countries means that these measures will prove a drag on growth for the next couple of years at the very minimum. The yields on the peripheral Euro area members continued to creep up over the first half of June but have stabilised somewhat since then with the exception of Greece – whose 10 year yields are now above 10%. The concern over debt and deficits in the Euro area remains and the situation is not likely to improve in the short term. Most Governments in the Euro area are now implementing or plan sizable fiscal consolidation and the markets may be giving them – a little – breathing room to see if they are really committed to putting their houses in order.

…while Trichet give little away about ECB plans…

ECB President Trichet was quizzed thoroughly at his press conference after June's Governing Council meeting about ECB debt purchases but he gave little away, noting only that "it's appropriate to continue to do what we've decided" as the money market is not functioning perfectly. He gave no indication of how long the debt purchases and unlimited loan offerings would last, saying they were "temporary" measures and that bond purchases would be sterilised. He said that participants in the markets did not need full information about what the ECB is doing right now, saying the "purpose (of the programs) has been very clearly said and we think that we give enough information at this stage". He rejected any criticisms of the programs, saying that all non-standard measures taken by the ECB were consistent with its mandate. He added the ECB will do what it judges to be appropriate to help restore the normal functioning of the monetary policy transmission mechanism. Trichet is not worried about the survival of the Euro, as it is a "very credible currency" which had kept it value exceptionally well in an eleven and a half year period during which the ECB had kept inflation close to 2%, which in his opinion was a much better performance than other central banks.

…but says fiscal consolidation is needed regardless of short term impact on growth.

On the outlook for the economy, he said the recovery had continued in 2010 and would expand at a moderate pace this year despite the environment being highly uncertain. Inflation pressures are contained over the medium term with inflation expectations firmly anchored. The economic rebound had picked up in the spring and the ongoing global recovery was helping EA exports. Growth is likely to be uneven over the coming years. The ECB staff forecast for GDP growth this year was revised slightly upwards to between 0.7% and 1.3% from between 0.4% and 1.2%; however next year was revised slightly down to between 0.2% and 2.2% from 0.5% to 2.5%. The inflation outlook was revised slightly up to 1.4% to 1.6% this year and 1.0% to 2.2% next year. While fiscal consolidation can restrict growth in the short term, Trichet made it clear that it is crucial that Governments take extra measures where needed to ensure sustainability of the public finances. Even though the ECB revised up the inflation outlook there is no sign of any real inflation pressures in the Euro area with core inflation close to record lows. Given the turmoil in the markets, the ECB is moving away from any talk of exit strategies and the situation is likely to push out interest rate increases even further into 2011. The ECB may not be saying much but Trichet seems to be firmly focused on reminding the market that the ECB will do what is right and increasing non standards measures is firmly in the bank's mandate if that is what they believes needs to be done to fix the system.

United States

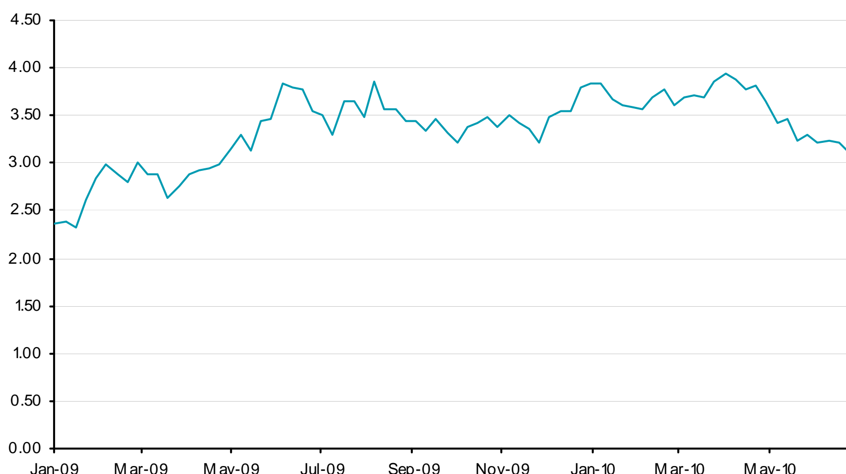
Government bond yields fall further

Bond yields fall…

Government bond yields have fallen further over the past month, with the benchmark 10-year yield down about 35bps to just under 2.95%, its lowest level in a year. Stocks have lost further ground over this period, with the S&P 500 off around 5% since the end of May. The dollar is largely unchanged against the euro at around $1.23, though it traded up to a high of almost $1.18 and down to a low of $1.25 during the course of the month.

The sovereign debt crisis in Europe and the associated increase in risk aversion have contributed to the fall in government bond yields which has been in train now since early April, when 10-year yields were a full percentage point higher at almost 4%. However, some softer than expected (US) economic data have also contributed to the further decline in yields over the past month. Most notable in this regard was the employment report for May. Though it showed payrolls increased by 431k in the month this was almost fully accounted for by government hiring of temporary employees to work on Census 2010. Private employment rose by just 41k, a much smaller increase than recorded in March and April. There was also a downward revision to the previous estimate of GDP growth in the first quarter, to 2.7% from 3% (and 3.2% in the preliminary estimate), while, more worryingly, final demand growth was revised down from 1.4% to 0.8%, which is about half the pace of growth recorded in the final quarter of 2009.

US 10-year Government Bond Yield



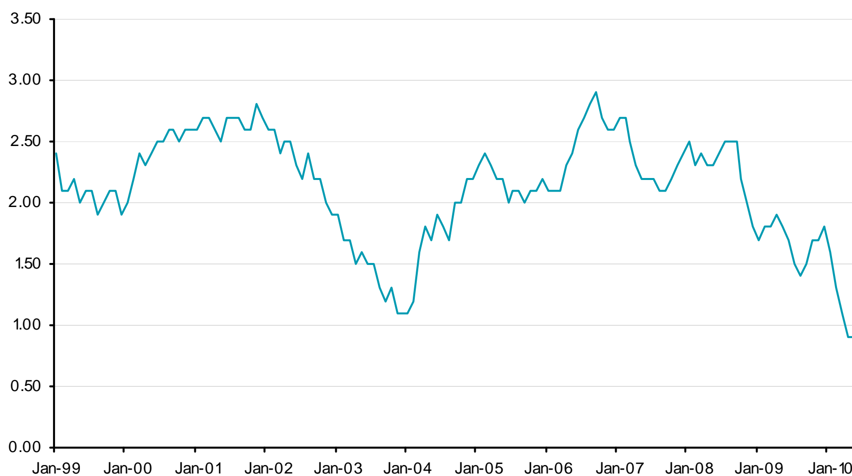
…amid concerns about growth outlook…

The Fed also raised some concerns about the growth outlook at its monetary policy meeting in late June. Though it did note that the economic recovery is "proceeding", with both consumer spending and business investment rising, it also said that "financial conditions have become less supportive of economic growth on balance, largely reflecting developments abroad", this obviously a reference to the fall-out from the Euro area debt crisis. This suggests the Fed may have revised down its forecast for GDP growth - the minutes to be published in mid-July will show if this is the case – though any such revision is likely to be small, given that a number of Fed members have also argued that the impact of the crisis in Europe on the US economy should be limited enough.

…inflation falling…

However, the Fed already expects only a very gradual fall in the unemployment rate over the next couple of years, so any downward revision to the growth outlook would imply an even slower decline from the current elevated level of almost 10%. It would also heighten its concerns about the outlook for inflation. Indeed, the Fed noted at the June meeting that "underlying inflation has trended lower", with the annual rate of core CPI inflation of just 0.9% in May down almost a full percentage point from the end of last year and its lowest level in almost 50 years. It is also well below the level the Fed would likely to see on a sustained basis, which is closer to 2%. Inflation is likely to remain below 2% for a while yet though, as the Fed again indicated in its June statement. It said that the substantial margin of spare capacity that currently exists in the economy is likely to continue to restrain cost pressures and hence "inflation it likely to be subdued for some time".

Core CPI Inflation (%)



…and Fed firmly on hold.

Not surprisingly, then, the Fed has reiterated that exceptionally low interest rates are likely to be warranted for an 'extended period', thus maintaining the stance that has been in place now since December 2008. The market has also pushed out the expected timing of the first hike in interest rates to the second quarter of 2011 from quarter one previously. This may restrain the dollar's rally against the euro, which seems to have run out of steam. Hence we retain our view that the dollar is likely to trade in a range of $1.20-$1.25 over the second half of the year.

July

	Europe	United Kingdom	United States
1	PMI Manufacturing, German Retail Sales	PMI Manufacturing	ISM Manufacturing, Pending Home Sales
2	PPI's		Non farm payrolls, unemployment, Factory Orders
5	PMI Service, Retail Sales	PMI Services	
6			ISM Non-Manufacturing
7	GDP Q1 Final, German Factory Orders		
8	ECB meeting, German Industrial Production	BOE Meeting, Industrial Production	
9		PPI's	
12		Consumer Confidence, GDP Q1 Final	
13	ZEW Survey	Inflation data	
14	Inflation, Industrial Production	Unemployment rate	Retail Sales, FOMC Minutes
15			PPI's, Industrial Production, Philly Fed
16			Inflation Data, University of Michigan Confidence
20			Housing Starts
21		Bank of England Minutes	
22	Industrial New Orders, Consumer Confidence	Retail Sales	Leading Indicators, Existing Home Sales
23	IFO Surveys	GDP Q2	

Forecasts

Bank of Ireland estimates

Exchange Rates

	Current	End Sep	End Dec	End Mar
EUR/USD	1.23	1.20	1.20	1.18
EUR/GBP	82.5	0.80	0.80	0.78
USD/JPY	88	94	100	105
GBP/USD	1.49	1.50	1.50	1.51

Source: Bank of Ireland Global Markets

Official interest rates

	Current	End Sep	End Dec	End Mar
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 Sep	End Dec	End Mar
US	2.06	2.75	3.50	3.75
Eurozone	2.10	2.50	2.75	3.00
UK	2.47	3.00	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	1.4	1.4	1.5
UK	1.2	3.0	2.3	2.0

Source: Bank of Ireland Global Markets

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Market data supplied by Thomson Reuters

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