Produced by the Economic Research Unit
October 2012

Bank of Ireland
Global Markets

TheBulletin

A monthly analysis of international and Irish markets

Ireland's Savings Ratio

- The ratio was thought to be in double-digits
- Latest CSO figures show big fall in last few years

Consumer spending in Ireland fell by over 2% in the first half of the year, bringing the decline over the past four years to 10%, which may go a long way to explain why most people still refer to 'the recession' even though Irish GDP bottomed in late 2009 and has recovered some ground since. Falling incomes are seen as the key factor behind this fall in consumption but there is also a widely held view that households are saving more and attempting to repay debt; the stock of mortgage debt is indeed falling and outstanding credit card balances currently stand around €2.5bn from some €3bn at the peak of the cycle.

The savings ratio as reported by the CSO in the quarterly sectoral accounts also support the view that households are spending a smaller proportion of disposable incomes; the ratio rose to 13.9% in 2011 and to 14.2% in the first quarter of this year from 7.6% in 2007. Savings in this context simply means that portion of disposable income not spent, so it need not equate to a flow into 'savings products' as a decision to repay debt, and hence reduce spending, would emerge as a rise in the savings ratio.

Some analysts put great store on the savings ratio as a key driver of consumption, including the IMF, who recently produced research on the Irish economy based on the view that the savings ratio would remain high for some time, declining only slowly from an estimated 14% in 2011, hence dampening consumer spending in the short-term but acting as a potential support for consumption in the future. Unfortunately for this theory, the CSO recently published updated estimates for the savings ratio on a national accounts basis, as used in the IMF study, which shows a dramatic fall in the ratio over the last few years. This measure, known as the net savings ratio, shows a fall from 11.4% in 2009 to 6.8% in 2010 and 5.4% in 2011 and hence implies a very different picture to that often painted – Irish households appear to have reacted to the plunge in disposable incomes by reducing their savings in an attempt to support consumer spending. In the absence of data revisions (which are quite possible) the latest figures do not support the idea that consumer spending could receive a big boost from a reduction in the savings ratio, nor the view that it is still unusually high.

Dr. Dan McLaughlin.

United Kingdom

Economy to have rebounded in Q3

Economy contracted again in Q2…

The UK economy contracted by 0.4% in the second quarter according to the latest national accounts data, a little less than the 0.7% fall in GDP initially reported. This still marked a third consecutive quarter of negative growth however, and left the level of GDP some 0.5% below that in the corresponding quarter in 2011. All the components of final domestic demand - consumer spending, investment, government consumption – fell in Q2 from Q1 and together reduced GDP by 0.9% points. Exports also fell, while imports rose, with the result that *net* exports reduced GDP by a further 0.8% points. It was only because of a re-building of inventories – which contributed more than 1% point to GDP – that the contraction in the economy was limited to 0.4%.

…though rebound likely in Q3…

One-off factors, notably the Jubilee celebrations in June, did contribute to the weakness of the economy in the second quarter. This is obvious from the almost 3% fall in manufacturing output and the 1.5% decline in services sector output that occurred in the month of June, according to the official data. Output in these two sectors did rebound in July however – by 3.2% and 1.1% respectively – meaning it is likely that GDP rebounded in the third quarter, with the latest estimates pointing to an increase of 0.6%. However, based on the more timely survey data, which point to some renewed weakening of activity at the end of the quarter, it seems the economy is essentially bouncing along the bottom. It should be noted, though, that the performance of the economy, as measured by GDP, sits uncomfortably with the behaviour of the labour market, where employment rose sharply and the unemployment rate declined further over the three months to July. Either the economy is not as weak as the GDP data have been suggesting, or labour productivity has weakened sharply meaning the economy's potential rate of growth is now much lower than before.

…MPC in 'wait and see' mode…

Having announced further QE and a new 'funding for lending' (FLS) scheme in July (the latter designed to boost credit to the household and business sectors), the Monetary Policy Committee (MPC) of the Bank of England has kept policy on hold in the intervening period, although its August inflation report showing an undershoot of the 2% target over the medium term would on the face of it have pointed to a further easing of policy by now. The MPC has however become a little more concerned about the inflation outlook since August given the renewed rise in oil prices and the knock-on effects on energy price inflation, though more fundamentally it has decided to adopt a 'wait and see' stance as it assesses the impact of additional QE and the FLS on the economy. There are, however, differing views amongst members of the Committee regarding future policy action, with some believing that additional stimulus will more likely than not be warranted in due course but others judging the risks to meeting the 2% inflation in the medium term as being more balanced and hence presumably less inclined to ease policy further. Overall, policy is likely to remain unchanged at least until the November meeting, when the MPC will have updated forecasts for growth and inflation.

…sterling gives up some ground to euro.

Having strengthened from 84p to the euro to 78p as the euro area debt crisis intensified between April and July, sterling has since given up some ground and currently trades at around 80p. Activation of ECB bond buying might give a further fillip to the euro in the short-term, and any additional QE by the MPC could also weigh on sterling. However the ECB is likely to ease policy also through a reduction in the refinancing rate, while its bond buying will not cure all the ills afflicting the zone (there are difficulties relating to Greece, the creation of a single EU banking supervisor and the scope of direct bank recapitalisation by the ESM) so the single currency is likely to remain under pressure on the exchanges. Overall, we think a range of 78p to 82p for EUR/STG is now in prospect.

Europe

ECB announces Outright Monetary Transactions

ECB details proposed bond buying…

The ECB outlined details of its planned bond purchases in the *secondary* markets, to be called Outright Monetary Transactions (OMTs), following the Governing Council meeting in early September. According to the central bank, OMTs will enable the ECB to 'address severe distortions in government bond markets which originate from, in particular, unfounded fears on the part of investors of the reversibility of the euro' and which 'hamper the proper transmission of our (monetary) policy stance to the real economy'. However, any bond purchases will be conditional on a country applying for financial assistance from the EFSF/ESM in the form of a full macroeconomic adjustment programme or a precautionary programme i.e. a credit line provided they include the possibility of EFSF/ESM *primary* bond market purchases. Even then, the ECB will retain full discretion over whether to commence bond purchases. Any bond buying will be concentrated at the shorter part of the yield curve, and in particular on sovereign bonds with a maturity of between one and three years. No ex ante quantitative limits will be set on the size of Outright Market Transactions. The ECB will rank equal with private creditors with respect to bonds issued by euro area countries and purchased by the ECB through OMTs.

…but bond purchases depend on country requesting assistance…

Though the ECB has not yet conducted any OMTs peripheral bond yields have still fallen sharply. Not surprisingly the largest decline in yields has been at the shorter part of the yield curve; 10-year yields in the case of Spain and Italy have come down by more than 150bps from the highs of mid-summer. There is no guarantee though that yields will remain low in the absence of actual ECB bond purchases. The latter depends on a country – read Spain – formally requesting financial assistance but no such request has been made to date. The Spanish government is planning a major fiscal consolidation to reduce the budget deficit next year (to 4.5% of GDP in 2013 from an expected 6%-plus in 2012) and has outlined a series of structural reforms (to the labour market and other parts of the economy), while the results of the country's bank 'stress tests' have been announced and a capital shortfall of just under E60bn identified. This may now pave the way for the government to make a formal request for assistance from its euro area partners, which in turn would probably prompt an activation of OMTs (albeit only after the EFSF/ESM first becomes active in the primary bond market). While it is probably fair to say that the patience of the markets is not yet being tested, they will give the benefit of the doubt to the Spanish government for only so long, particularly as there are other issues that could cause tensions including the Greek 'bailout' situation (it may need additional funding), the creation of a single supervisor (there is disagreement as to its scope) and the retrospective recapitalizing of banks by the ESM (some countries are against it). In the absence of a Spanish aid request fairly soon, the risk is that peripheral yields will drift higher and the euro, which has already come off its mid-September highs of over $1.31, will drift lower.

…euro area economy is still contracting.

The euro area economy, meanwhile, continues to struggle. Real GDP fell by 0.2% in the second quarter and the Purchasing Managers survey data point to a further fall in the third quarter. The unemployment rate hit another record high of 11.4% in August and has now risen by more than a percentage point in just a year, while inflation in the zone has re-accelerated mainly on account of higher energy prices with the annual rate standing at 2.7% in September from 2.4% in July. The ECB has revised down its forecasts for growth in 2012 and 2013 and now expects the economy to contract by 0.4% this year (from -0.1% previously) and to expand by just 0.5% next year (from 1% previously). It has also revised up its forecasts for inflation for both this year and next, to 2.5% and 1.9% respectively from 2.4% and 1.6% previously. Despite the re-acceleration in inflation recently and the upward revision to the 2013 outlook, the continuing weakness of economic activity means there is still scope for the ECB to cut the refinancing rate from the current level 0.75%.

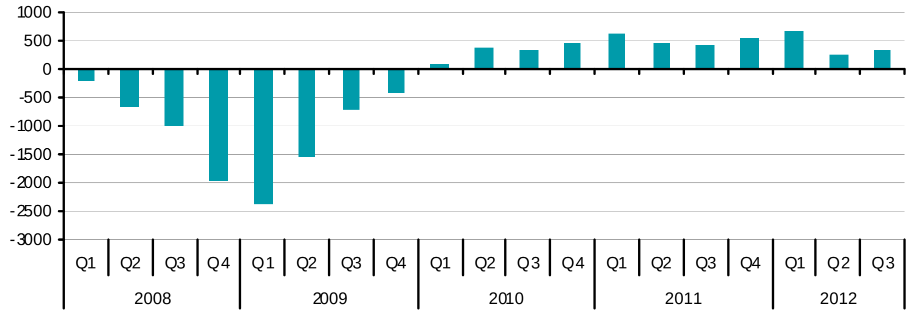
United States

Fed exceeds expectations with QE3

Fed acts to boost growth…

Heading into the mid September meeting, there was a clear anticipation that the Fed was about to embark on further monetary loosening but, in the event, it responded more aggressively than the market had anticipated. The Fed announced in June that is was easing monetary policy through 'Operation Twist', a program which will run to the end of this year and then said after the August meeting that it 'will provide further accommodation as needed to promote a stronger economic recovery". The minutes of the meeting revealed that 'many members' judged that additional monetary easing would likely be warranted 'fairly soon' unless incoming information pointed to a 'substantial and sustainable strengthening in the pace of the economic recovery'. The data over the past few months has suggested that economic growth is insufficient to create enough new jobs to eat into the 8%+ unemployment rate. The graph below illustrates that private payrolls growth since the end of the recession has not been sufficient to even replace the jobs lost and job creation has slowed in the last two quarters.

Change in US Private Payrolls since 2008 (by Qtr, in '000's)



…tying action to labour market developments…

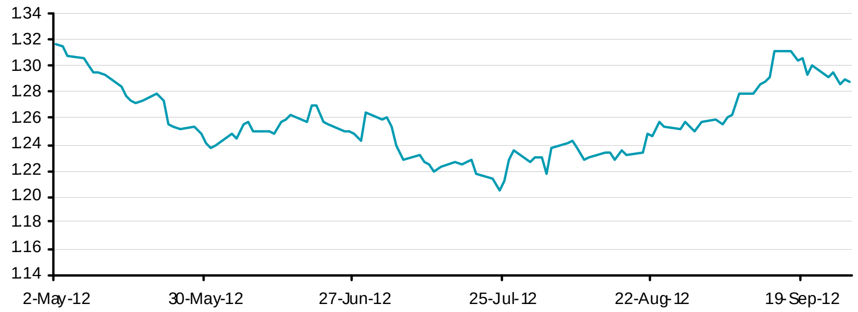
This is one of the key barometers for the Fed's policy action given its dual mandate of price stability and maximum employment. At the September 12/13 meeting the Fed did announce further easing to support the US economy with the package of measures exceeding market expectations and tying future action to developments in the labour market. The Fed will conduct a third round of quantitative easing (QE3) – buying mortgage-backed securities (MBS) at a pace of $40bn a month – and expects to maintain a 'highly accommodative stance of monetary policy for a considerable time after the economic recovery strengthens', with an exceptionally low level of interest rates now 'likely to be warranted at least through mid-2015' (extended from 'at least through late 2014' previously). The $40bn in MBS purchases will be on top of the $45bn in longer-term government bonds the Fed is purchasing under 'Operation Twist', which is due to expire at the end of this year, so bringing total asset purchases to $85bn a month between now and year end. Moreover, and significantly, the Fed said it will closely monitor developments in coming months and, if the "outlook for the labour market does not improve substantially', it will "continue its purchases of MBS, undertake additional asset purchases, and employ its other policy tools (mainly 'forward guidance' on interest rates) as appropriate until such an improvement is achieved". This is an extremely forceful and open-ended commitment by the Fed to continue to provide stimulus to the US economy until it achieves its desired objective, which is a substantial improvement in labour market conditions.

As Bernanke told the post-meeting press conference, the Fed hopes that, in addition to the effects its actions will have on monetary and financial conditions, its commitment to effectively do whatever it takes to support the economy will boost business and consumer confidence and so help bring about the improvement in economic and labour market conditions that it desires.

...dollar slips but should regain ground in months ahead...

The anticipation that the Fed would ease policy at the September meeting had caused the dollar to depreciate over the summer months. The greenback slid from close to $1.20 to the Euro in late July to $1.29 just before September's Fed meeting. The impact of the Fed's decision was to put further pressure on the dollar which declined to over $1.31 in the days after the meeting. We think, however, that the Euro will struggle to hang on to these gains. The debt crisis is still raging in Europe and that could put downward pressure on the Euro in the months ahead, the ECB has also not closed the door on cutting interest rates again which would also push down on the Euro and finally, the economic outlook in the US –which is for modest growth - is considerably better than the outlook for the Euro area economy which is likely to post a contraction in activity in 2012. We think the currency cross will reflect those fundamentals and despite the huge amount of stimulus being pushed into the system by the Fed the dollar should gain over the course of the year.

EUR/USD Exchange Rate since May 2012



as signs emerge that growth is picking up

The latest estimate of US Q2 GDP was disappointing, confirming that growth had slowed to just 1.3% (annualised) in the quarter (down from an initial estimate of 1.7%) from 2.0% in Q1 and a recent peak of 4.1% in Q4'11. This slowdown in the pace of growth caused the Federal Reserve to revise down their forecasts for GDP growth this year. The September forecasts show that the Fed expects growth of 1.7% to 2.0% this year down from a projection of 1.9% to 2.4% in the June forecasts. However, the most recent data now indicates that growth may be picking up. The latest ISM survey data showed that the manufacturing index picked up to 51.5 in September following three months of contractionary (below 50) readings. For the third quarter as a whole, the index averaged 50.3 down from an average reading of 52.7 in Q2, implying that the sector grew very marginally in the quarter but was picking up again heading into Q4. Similarly, the services index increased to 55.1 in September from 53.7 in August leaving the average reading for Q3 at 53.8, slightly up from the average of 53.1 in Q2 and strengthening in each month of the quarter. This survey data adds to other evidence of an improvement in activity including retail sales, which increased in July and August, consumer confidence, which rose to a 7 month high in September, personal spending, which is averaging 0.6% higher so far in Q3 (up to August) compared to Q2 levels, and a raft of housing data which shows that a recovery in the housing market appears to be in train. Against this, business investment appears to have slowed in the face of weaker external demand; capital goods orders have fallen over 5% in the first two months of Q3 from the average level in Q2. However, on balance, the momentum seems to favour stronger growth in the last quarter of 2012 and beyond.

Economic Diary - October

	Euro Zone	United Kingdom	United States
1	PMI Manufacturing, Unemployment	PMI Manufacturing, Mortgage Approvals	ISM Manufacturing
2	PPI's	Nationwide House Prices, PMI Construction	
3	PMI Composite, PMI Services, Retail Sales	PMI Services	ISM Non-Manufacturing, ADP Employment Change
4	ECB Meeting	BoE Meeting	Initial Jobless Claims, Factory Orders, FOMC Minutes
5	German Factory Orders		Non-Farm Payrolls, Unemployment Rate
8	German Industrial Production		
9		Industrial Production, RICS House Price Balance	NFIB Small Business Optimism
10			Fed's Beige Book
11			Initial Jobless Claims
12	Industrial Production		PPI's, Uni. Of Michigan Confidence
15		Rightmove House Prices	Empire Manufacturing, Retail Sales
16	Inflation Data, ZEW survey	PPI's, Inflation Data	Inflation Data, Industrial Production
17		BoE Minutes, Employment Data	Housing Starts
18		Retail Sales	Initial Jobless Claims, Philly Fed, Leading Indicators
19			Existing Home Sales
23	Consumer Confidence		
24	Advance PMI's, IFO surveys	CBI Surveys	FOMC Meeting, New Home Sales, Markit PMI
25		Q3 GDP	Durable Goods Orders,Initial Jobless Claims, Pending Home Sales
27			3Q GDP
29			Personal Income & Spending
30	Confidence Data, German Retail Sales		
31			S&P CaseShiller Home Prices, Consumer Confidence, Chicago PMI

Forecasts

Bank of Ireland estimates

Exchange Rates

	Current	End Dec	End Mar	End Jun
EUR/USD	1.30	1.25	1.20	1.25
EUR/GBP	0.80	0.80	0.80	0.80
USD/JPY	79.5	80	82	85
GBP/USD	1.62	1.56	1.50	1.56

Source: Bank of Ireland Global Markets

Official interest rates

	Current	End Dec	End Mar	End Jun
USD	0-0.25	0-0.25	0-0.25	0-0.25
EUR	0.75	0.5	0.5	0.5
GBP	0.50	0.5	0.5	0.5

Source: Bank of Ireland Global Markets

Swap rates: 5 year

	Current	End Dec	End Marc	End Jun
US	0.80	0.8	1.0	1.25
Eurozone	0.95	1.0	1.0	1.00
UK	1.00	1.10	1.00	1.00

Source: Bank of Ireland Global Markets

GDP and inflation (annual average)

	2012		2013	
	GDP	Inflation	GDP	Inflation
US	2.2	2.0	2.2	2.0
Eurozone	-0.4	2.4	0.5	1.6
UK	0.0	2.6	1.5	1.8

Source: Bank of Ireland Global Markets

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