Bank of Ireland

Economic Research Unit

July 2015

Markets calm as Greece dominates

Overview Greece has dominated the headlines recently. A failure to conclude the country's second 'bailout' programme has led to bank closures and the imposition of capital controls, while the Greek electorate rejected creditors' proposals underpinning the programme in a referendum. Markets have remained calm, though, even as the chances of a 'Grexit' increased. Peripheral yields did spike higher for a time and spreads over Germany widened out, though to nothing like the levels reached during the 2012 debt crisis. Markets seemed reassured that the ECB would take any action necessary to maintain stability, while also perhaps believing that ultimately a deal would be reached that avoided a Greek exit. They seem to have been proved correct on the latter as Euro area leaders have in principle agreed a third financial assistance programme, albeit there are some hurdles to be overcome before formal negotiations can begin. EUR/$ has ebbed and flowed in tandem with developments in Greece while remaining in the $1.10-$1.15 range that has prevailed since late April. The focus should now shift to the prospect of an increase in US interest rates. Fed Chair Yellen believes it will probably be appropriate to raise rates 'later this year' - some of her colleagues have said a September hike is 'in play' - though the market is not pricing in a full 25bps increase until early 2016. If the Fed does act sooner than the market expects, then the dollar should strengthen over the latter part of this year.

Euro area recovery continuing

UK growth reaccelerating

US employment falls further

Diary

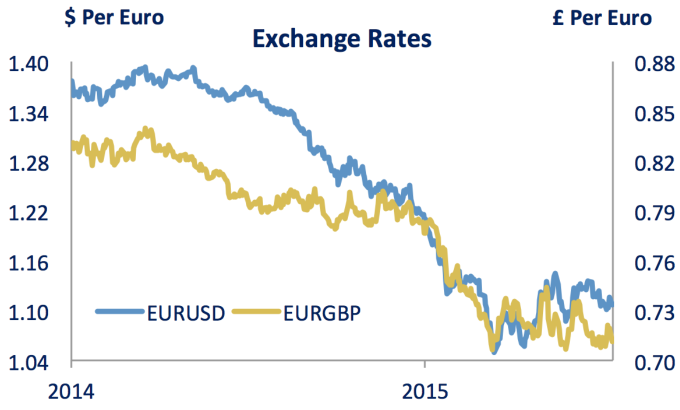
	Euro Area	UK	US
Central Bank Meetings	Jul 16	Aug 6	Jul 29
GDP	Aug 14	Jul 28	Jul 30
Inflation	Jul 31	Jul 14	Jul 17
Labour Market	Jul 31	Jul 15	Aug 7

Forecasts

	End Sep 2015	End Dec 2015	End Mar 2016	End Jun 2016
Exchange Rates				
€/$	1.08	1.06	1.05	1.05
€/£	0.71	0.70	0.70	0.70
£/$	1.52	1.51	1.50	1.50
Swap Rates (5 year)				
Euro Area	0.60	0.70	0.80	1.00
UK	1.80	2.00	2.30	2.50
US	2.00	2.30	2.60	2.80

Euro Area recovery continuing

Recent data suggest GDP growth in the second quarter was maintained at around the same pace as Q1 (0.4% q/q). The composite PMI increased for a third consecutive quarter in Q2, to 54.2, with both manufacturing and services strengthening further. Retail sales rose in April and May, and manufacturing output in April was running ahead of its level in Q1. The IMF expects GDP growth of 1.5% and 1.7% in 2015 and 2016 respectively, the latter revised up from 1.6% previously. Annual CPI inflation fell in June but remained in positive territory at 0.2%, while the unemployment rate remained unchanged at 11.1% in May. Markets have remained relatively calm as the Greek crisis has intensified over the past month. They seem to have been reassured that the ECB would take whatever action necessary to maintain stabiltiy, while also perhaps believing that ultimately a deal would be reached to keep Greece in the single currency. The euro has ebbed and flowed against the dollar in recent weeks but has remained within the $1.10 to $1.15 range in place since late April.



UK growth reaccelerating

Annual GDP growth in 2014 was revised up to 3%, the strongest outturn since 2006. Q1 2015 was also better than initially estimated with growth revised up to 0.4% q/q. The pace of activtiy appears to have picked up in Q2 driven by a reacceleration in services sector growth – the services PMI rose to 58.2 in Q2, its highest level since the 3rd quarter of last year. Employment rose further in the three months to April and the unemployment rate fell to 5.5%, while earnings growth is picking up which will support consumer spending. Fiscal policy is likely to act as a drag on activty this year, however, and the Chancellor of the Exchequer has revised down his forecast for GDP growth a little to 2.4% (though 2016 is unchanged at 2.3%). The IMF is projecting growth of 2.4% and 2.2% respectively Annual inflation is back in positive territory but remains subdued at just 0.1%. The BOE's MPC kept interest rates unchanged at 0.5% in July and the market has pushed out the timing of a first hike to the 3rd quarter of 2016. Sterling has firmed to around 71p against the euro.

US unemployment falls further

Q1 GDP growth is now put at flat q/q, from -0.2% previously, due to upward revisions to consumer spending and investment. Activity has rebounded recently judging by a range of indicators. The ISM manufacturing index rose for a 2nd consecutive month in June led by an increase in new orders, while consumer spending grew at its fastest pace in over a year (up 0.6% from May). Employment is increasing at a solid pace, with over 200,000 jobs added last month, and the unemployment rate (5.3%) has fallen to its lowest level since 2008. The IMF has lowered its forecast for GDP growth in 2015 to 2.5% (reflecting Q1 weakness) but expects the economy to expand by 3% in 2016. The Fed kept interest rates unchanged in June but noted that economic conditions are 'approaching those consistent' with a first increase. Some Fed members have said a September move is 'in play', though the market is not pricing in a full 25bps hike until early 2016. 10-year yields are up about 20bps over the past month to around 2.45%.

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