Monetary and Financial Market Developments

Overview

Global financial markets have, in general, showed signs of normalising in recent months, due to a gradual return of trust and confidence and some positive economic data, combined with the ongoing fiscal and monetary support being provided by governments and central banks. However the economic environment remains uncertain, which has led to mixed signals coming from various sections of the markets and some volatility in recent months, albeit at much lower levels than experienced during the height of the crisis in late 2008.

The recovery in equity markets continued both in Ireland and internationally in the period from end-June 2009 to mid-September 2009, with the recovery being particularly marked for companies in the financial sector. Concerns remain however about the sustainability of this trend, given the fragile state of the major advanced economies. Meanwhile yields on government bonds, particularly of shorter maturity, continued to drift downwards, despite some underlying volatility, which reflected investors' uncertain expectations of economic developments, fiscal sustainability and the direction of monetary policy. In more recent weeks this level of uncertainty has declined, as investors seem more confident that a global economic recovery is underway, but that it is likely to be protracted and weak through the short to medium term. Longer term sovereign bond yields for most major economies have remained relatively unchanged or decreased slightly in recent months. However, the yield curve steepened towards the end of the period for many sovereigns, including Ireland, reflecting concerns about the nature of the economic recovery along with rising levels of public sector borrowing.

In the light of subdued inflationary pressures and the severe economic downturn, the major central banks have continued to orient monetary policy in a very accommodative way with continuing low short-term interest rates. Combined with the various government or central bank support schemes to the financial sector, this has contributed to an easing of strains and an improvement of confidence in money markets generally, and a reduction in key risk-spreads through 2009. In the euro area, risk spreads in the inter-bank market are now back to levels last seen in early 2008. The level of inter-bank borrowing rates have continued to fall to historically low levels, with the key 3-month Euribor rate being consistently lower than the ECB main refinancing rate since early July 2009.

While these developments are broadly positive, activity in some sectors of the wholesale markets is still muted. The reductions in wholesale market rates have, to date, been passed through to lending rates for businesses and households in the euro area generally, and particularly so in Ireland. Deposit rates, however, have not responded in a similar fashion as competition for deposits to support banks' balance sheets has remained strong. There have been some signs recently, however, that high street variable lending rates in Ireland are beginning to increase, following their previous decline, to protect margins in advance of the expected gradual increase in inter-bank lending rates and potential losses as a result of bad debts.

Developments in wholesale funding markets, combined with the balance sheet constraints of lenders and weak credit demand, reflecting general economic conditions, have led to a fall in domestic private-sector credit (PSC) in recent months. While valuation effects, such as increased write-downs and provisions for bad and doubtful debts account for most of the recent fall in headline credit, the underlying stock of PSC was marginally lower on a year-to-date basis by end-August 2009. The Government published the draft legislation on the establishment of the National Asset Management Agency (NAMA) in July, aimed at alleviating the balance sheet constraints of banks. It is proposed that NAMA will, by purchasing loans for development land and property investments, remove uncertainties about the effects on banks' capital arising from losses on these loans. Stronger bank balance sheets as a result of the NAMA process will improve banks' funding position and enhance the banks' capacity to lend to the real economy.

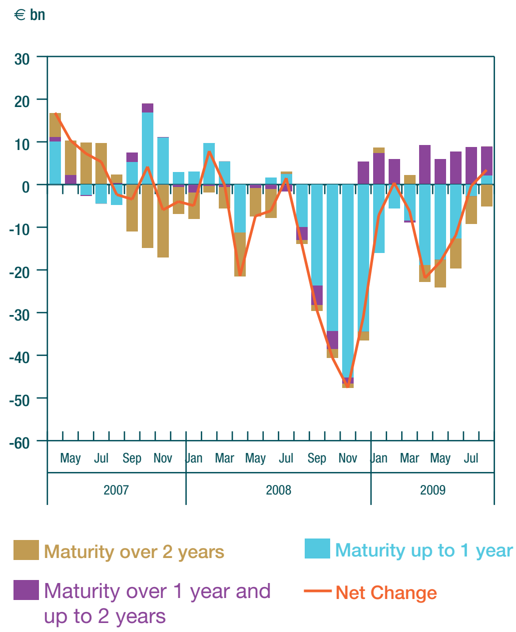
A: Financial Markets

Bank Funding and Money Market Developments

The bank wholesale funding markets have shown signs of improvement in most recent months. The Irish results of the latest euro-area Bank Lending Survey (BLS) showed that although Government announcements regarding recapitalisation support and State guarantees continue to assist retail banks, access to wholesale funding remained challenging across the maturity spectrum during the second quarter. However more recent developments show that MFI debt securities issued have increased throughout the three months to end-August after experiencing a continued fall in late 2008 and early 2009. This recent improvement was driven by an increase in debt securities with an original maturity between one and two years. Domestic banks were particularly active in issuance at this maturity, as would be expected under the terms of the Government guarantee scheme. There has also been a reversal in the trend of steep falls in the balances outstanding of short term notes. Longer term debt securities (with maturity greater than two years) have been the most stable debt up to Q2 2009, primarily due to their longer maturity, as there has not been a need to refinance these. Recent months have seen a fall in the outstanding balances of these longer maturity bonds, however, indicating that some are now beginning to mature. There is also some early evidence of Irish credit institutions beginning to issue new longer term debt outside of the guarantee scheme. Accompanying these trends in the maturity structure of Irish resident MFI debt securities, there has been some change in the geographical breakdown of holders of these securities. Domestic holdings of Irish resident MFI debt securities have increased over the year to date, whereas non-domestic holdings have declined.

ECB actions in recent months have continued to contribute to the gradual normalisation of conditions in euro-area money markets since the intensification of financial market tensions in September 2008. Confidence is also returning to the markets as the broader economic outlook has become more favourable in recent months, despite expectations that the recovery will still be slow. Government support mechanisms across the globe are also beginning to remove the uncertainty around bank balance sheets which had led to the distress in money markets.

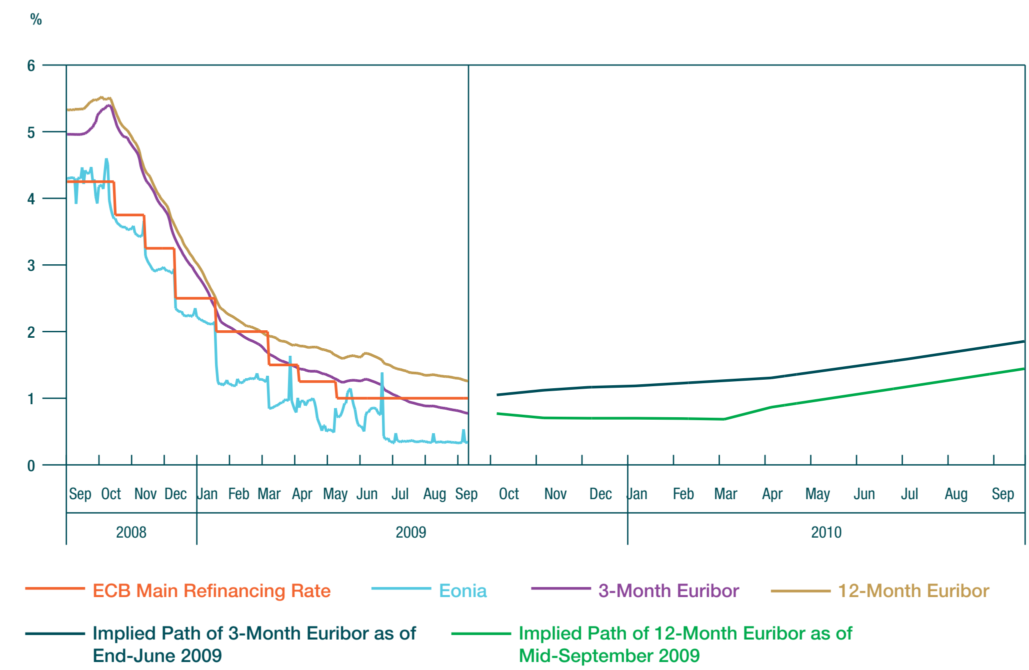
Chart 1: Net Issuance of MFI Debt Securities
(Rolling 3-month change)



Source: CBFSAI.

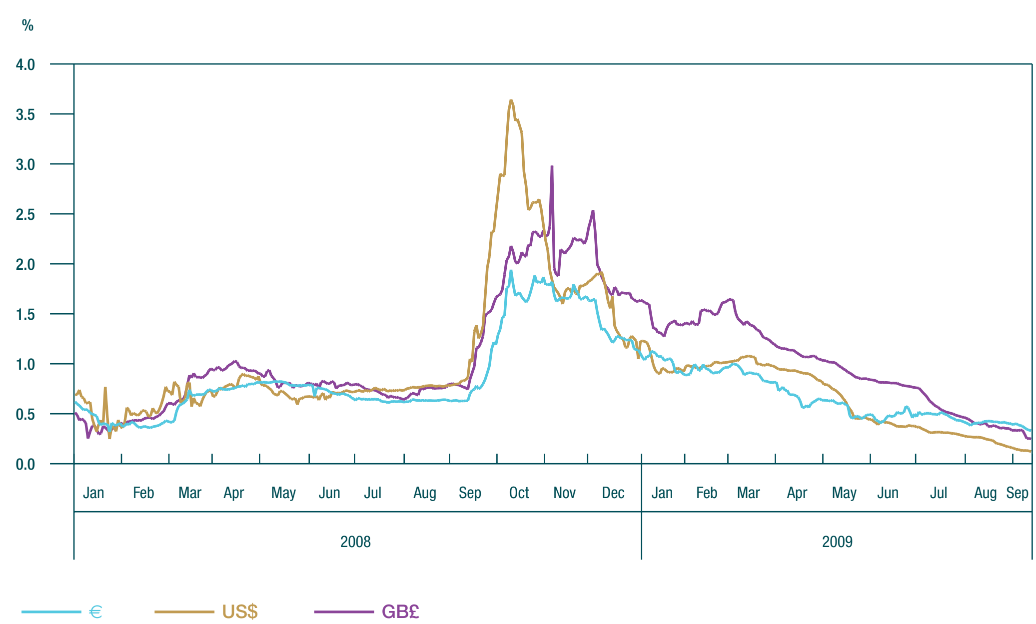
In its refinancing operations, the ECB continued to supply Irish and other Eurosystem counterparties with liquidity, through its full allotment policy for its main refinancing (MRO) and enhanced longer-term refinancing operations (LTRO). Following on from the 12-month LTRO in June, where €442 billion was allotted by the Eurosytem, demand in subsequent one, three and six-month LTROs was weaker as funding pressures were alleviated. Lending to credit institutions by the Irish Central Bank as part of the Eurosystem's monetary policy operations declined in July and August following the significant increase in June as banks availed of the new 12-month LTRO. In general there has been a structural shift out of shorter term refinancing with

Chart 2: Main ECB and Money Market Interest Rates



Source: CBFSAI and Bloomberg.

Chart 3: 3-Month Euribor (€) and Libor (GB£, US$) Spreads versus Overnight Index Swaps



Source: Bloomberg.

the Eurosystem towards the longer term in recent months across the euro area. This has led to reduced activity in the MRO auctions, as banks prefer to access funds at the longer horizon. The scale of the 12-month LTRO led to significant recourse to the ECB deposit facility towards the end of June 2009. However between then and mid-September, credit institutions' deposits with the Eurosystem have declined more, proportionately, than the amount borrowed in refinancing operations.

The ECB MRO rate remains unchanged at 1 per cent. Alongside the enhanced liquidity provision and more general uncertainty as to the speed and scale of the economic recovery, this has led to a flattening of the three-month euro money market curve in recent months. According to the implied path derived from three-month Euribor futures, market participants still expect interest rates to rise over the coming year from their current low base. However, by mid-September 2009, rates were expected to be lower through 2010 than had been expected at end-June 2009. In the overnight market, the Eonia rate has stabilised considerably since end-June, and has been on average 65 basis points below the MRO rate since then. The fall in the Eonia rate towards the end of June coincided with the first 12-month LTRO offered by the Eurosystem. Despite an initial widening of spreads between the 12-month and 1-month Euribor rates in early July 2009, longer term rates have since drifted downwards also, and by mid-September 2009 the yield curve had remained relatively unchanged from the end of the second quarter.

Consistent with a gradual normalisation in money markets, unsecured euro-area money market rates continued to fall between end-June and mid-September, as they have done through most of 2009. Spreads between unsecured and secured rates, as represented by Euribor-OIS spreads[1], declined further over the quarter and have now returned to levels last seen before the bankruptcy of US investment bank Lehman Brothers. The Euribor-OIS spread peaked at just under 200 basis points in October 2008 and by mid-September 2009 stood at less than 40 basis points, a level last seen in January 2008.

In July 2009 the Governing Council outlined the plan, already announced in May, to purchase €60 billion of covered bonds in the period up to June 2010. This programme is another element of the non-conventional measures being taken to ease tensions in credit markets. By mid-September 2009, the Eurosystem, including the Irish Central Bank, had purchased €12.8 billion of eligible covered bonds, mostly from secondary markets. There has been a significant reduction of approximately 100 basis points in risk spreads in this key market since the announcement of the Governing Council's plan.

Sovereign Debt Market

Irish Government bonds performed strongly in recent months with the five and ten-year yields falling by 74 and 87 basis points respectively from end-June to mid-September 2009. However the yield on the ten-year bond increased in late August, steepening the yield curve. The Irish bond spread *vis-à-vis* Germany narrowed significantly over the period; however Irish yield spreads remain the highest in the euro area. In terms of the ten-year yield, the differential tightened from 234 basis points to 162 basis points between end-June and mid-September.

[1] An overnight index swap (OIS) is an interest rate swap whereby the overnight rate is swapped for a fixed interest rate over a fixed period of time.

Table 1: Monetary Policy Operations: Ireland, 1 July to 9 September 2009

	No. of bidders	No. of bids	Amount bid	Amount allotted	Marginal rate	Weighted average
			€ million	€ million	%	%
Recent MRO[a]	11	11	21,025	21,025	1.00	1.00
Quarterly rolling average MRO	12	12	18,318	18,318	1.00	1.00
Recent LTRO[a]	3	3	1,740	1,740	1.00	1.00
Quarterly rolling average LTRO	5	5	7,515	7,515	1.00	1.00

[a] Data in the table refer to the latest refinancing operations at which bids were placed.

Source: CBFSAI.

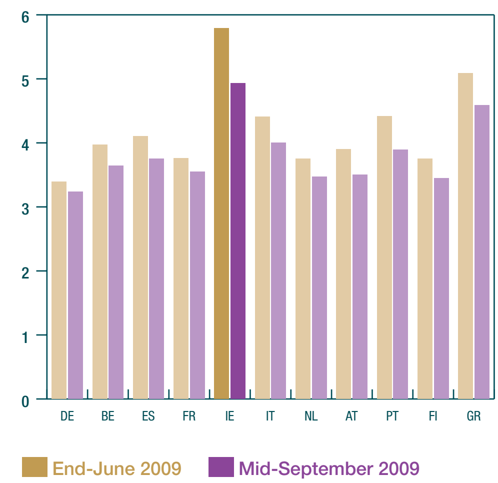
The yield spread on Irish Government bonds over German Government bonds is now significantly below the highest spread of 284 basis points experienced in mid-March. Both the yields and the corresponding spreads over German yields on Irish sovereign debt have followed a similar path to that of other euro-area sovereigns in recent months.

By mid-September the National Treasury Management Agency (NTMA) had raised its entire funding target for 2009 of €25 billion through both regular and syndicated auctions amid good demand. The funding strategy since early 2009 has included the reintroduction of short term Treasury Bills, with the stated aim of creating a liquid market for Government debt at the short end of the yield curve. To date they have conducted 11 auctions raising a total of €19 billion with bills ranging from one-month to one-year maturity. Demand for the bills has been high, especially from international investors. Meanwhile, market based measures of the risk of a sovereign default have eased for all euro area member states, and in particular for Ireland, in recent months. However the credit default swaps (CDS) spread on ten-year Irish Government debt is still above mid-2008 levels and comparable spreads for other euro-area sovereigns.

Chart 4: Irish Government Bond Yields and Spreads over German Equivalents

Source: Bloomberg.

Chart 5: Euro Area Ten-Year Government Bond Yields

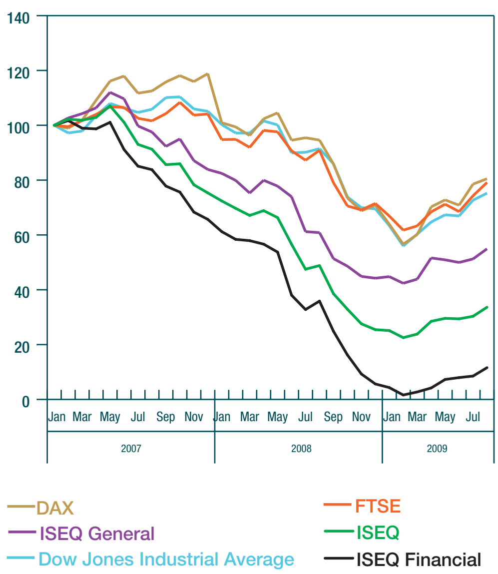


Source: Bloomberg.

Equity Markets

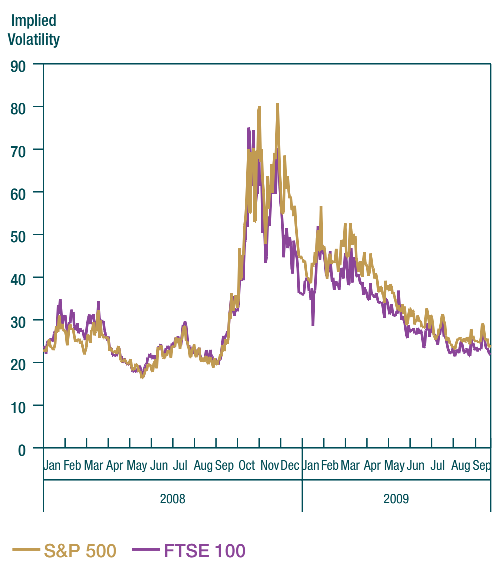
Equity markets around the world have performed strongly in recent months. The value of Irish shares as measured by the ISEQ index, increased by just over 32 per cent in the first eight months of 2009. At the end of August the index stood 64 per cent above its March low. Financial companies have been the big gainers so far in 2009 with the value of their equities more than doubling, albeit from a very low base. Improving investor sentiment, increased risk appetite on the back of hopes that the worst of the financial turmoil may have passed, and that the global economic recovery was gaining traction served to support most major equity markets throughout the world. It is important to note that the remarkable returns since March, particularly for financials, are from a very low level, with the ISEQ overall index reporting its lowest value in around 14 years and the Financial Index reporting its lowest ever value at that time. Although Irish shares in general outperformed global peers in the second quarter of 2009, the trend over Q3 2009 was largely mirrored by international indices. Volatility has also decreased from the highs experienced following the collapse of Lehman Brothers.

Chart 6: Irish and International Share Price Indices *(using end-month values)*



Source: Datastream.

Chart 7: Implied Equity Market Volatility



Source: Datastream.

Note: S&P 500 is the implied volatility of S&P 500 options taken from the VIX index. FTSE 100 is the implied volatility of FTSE 100 options taken from the FTSEIX index.

Foreign Exchange Developments

In the period from end-June to mid-September 2009 the euro strengthened against the dollar, continuing a trend evident through most of 2009. Against sterling, the euro clawed back some of the losses seen earlier in 2009 over the third quarter of the year. Positive economic data from the euro area over the period contributed to these movements. Furthermore, budget deficits are likely to be larger in the UK and US in the coming years than for the euro area as a whole. This is likely to have weighed on the value of the dollar and sterling *vis-à-vis* the euro. Over the period, the euro weakened slightly against the yen, as comments from the new Japanese finance minister reiterated that government's reluctance to devalue their currency. However on a year-to-date basis, the euro is still significantly stronger against the yen.

B: Money and Credit

Monetary Aggregates

The downward trend in the annual growth rate in Ireland's contribution to the euro area money supply (M3) was reversed in July 2009, when the growth rate rose from minus 8 per cent to minus 1.1 per cent, a level it remained at in August. The negative growth rate in Ireland's M3 had been driven by declining deposits and, to a much lesser extent falling money market fund shares/units. The monthly increases in M3 in July and August were broad based, reflecting increases in money market fund shares/units, overnight deposits and debt securities issued.

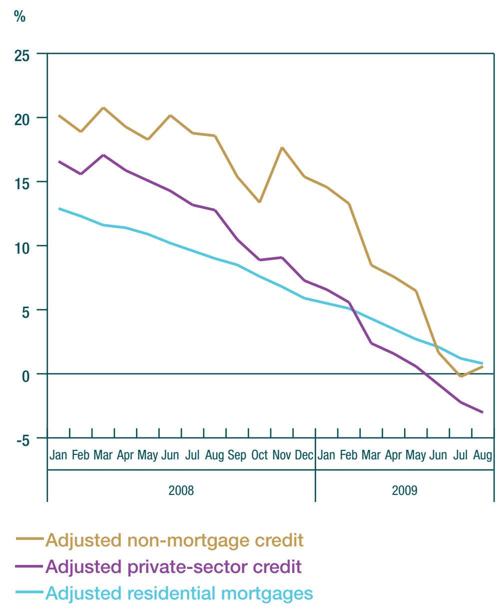
During 2008, M2-M1 was recording the highest growth rates in money supply, mostly due to the shift into deposits with up to two years maturity from shorter-term overnight deposits. This trend was reversed in 2009, with monthly falls in deposits with up to two years maturity being recorded each month, while overnight deposits started to increase in May 2009. Other short-term deposits, such as deposits redeemable at notice of up to three months, recorded a large annual growth rate of 44.6 per cent, and increased by €6 billion over the eight months to end-August 2009. These developments mirror those in the euro area as a whole, with the ECB reporting that relative returns appear to be influencing developments in the various types of short-term deposit. The available data on MFI interest rates for the period up to July show that the remuneration of short-term time deposits continued to decline relative to that of overnight deposits and short-term savings deposits. There may also have been increased re-allocation of funds to other longer term financial assets outside M3, such as equities.

Developments in Private-Sector Credit Advanced by Irish Resident MFIs

The annual growth rate of private-sector credit (PSC) became negative in June 2009, and had declined to minus 3 per cent by August. The June decline of minus 0.8 per cent was the first negative annual rate of change in PSC since the series was first compiled on the current basis in 1993. Current economic conditions affecting demand and the risk profile of borrowers, as well as balance sheet constraints of lenders have led to the decline in headline PSC. Survey evidence from the latest Bank Lending Survey (BLS) suggests that loan demand by households and non-financial corporates (NFCs) declined during the second quarter of 2009 while banks simultaneously tightened credit standards on loans.

Valuation effects, such as write-downs of existing credit arrangements and increased provisions for bad and doubtful debts, have contributed most to the fall in headline PSC over the year, as the underlying stock of PSC was relatively unchanged on an annual basis at the end of August 2009. Over the three months to August 2009, headline PSC declined by €6.4 billion. Within this, lending to NFCs declined by €4.8 billion. The fall in outstanding credit to NFCs was impacted by increased provisions, and sizeable write-downs, which accounted for just over 40 per cent of the decline in NFC lending over the three months. Credit advanced to other financial intermediaries (OFIs) increased by €5.7 billion in the first eight months of 2009. The financing by credit institutions of special-purpose vehicles (SPVs) by acquiring residential or commercial mortgage-backed securities is one of the factors behind the high growth rate of credit to financial intermediation companies. In many cases the credit institutions themselves were the originators of the loans underlying these securities and this exercise improves the

Chart 8: Annual Rates of Credit Growth



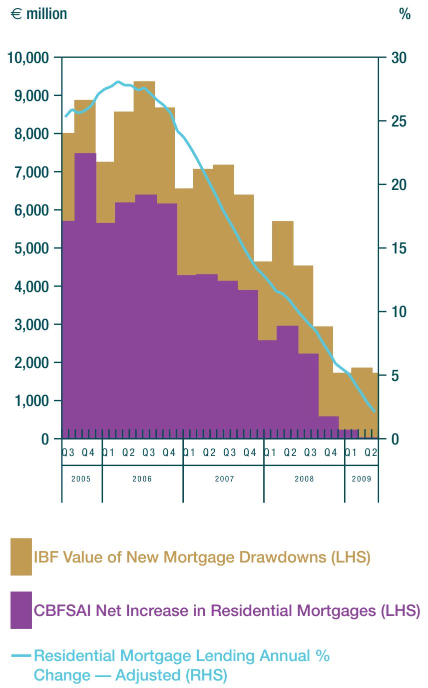
Source: CBFSAI.

liquidity profile of their balance sheets, while the net effect on total outstanding credit (PSC) is zero. In addition, a significant part of lending to the financial intermediation sector is not associated with the domestic economy; this would include, for example, lending to non-bank IFSC companies. Lending to non-bank IFSC companies has declined by over €2 billion so far in 2009.

The outstanding stock of residential mortgage lending (inclusive of securitisations) declined for the fifth consecutive month in August 2009. These are the first declines recorded in lending to households since records began. Mortgage debt outstanding declined on a year-to-date basis by €132 million by the end of August 2009, compared with a €7 billion increase over the same period in 2008. The annual rate of increase has also continued to fall and, in August 2009 reached its lowest level on record at 0.8 per cent.

The year-on-year change in outstanding consumer credit loans has been negative since March 2009, with credit outstanding falling by minus 9.9 per cent in the twelve months ending August 2009. The outstanding stock of

Chart 9: Quarterly Increase in Residential Mortgages — New Lending and Outstanding Amounts



Source: CBFSAI and the Irish Banking Federation.

loans has generally been falling since August 2008. The level of consumer credit outstanding in July 2009 was the lowest since October 2007. Outstanding indebtedness on personal credit cards is increasing at less than 2 per cent per annum since March 2009, compared with 19.7 per cent in March 2007. The volume and value of retail sales have been recording negative annual growth rates since early 2008, confirming the slowdown in consumer spending.

The latest data on the breakdown of residential mortgages relating to the second quarter of 2009 show declines in mortgages for buy-to-let properties and holiday homes of €37 million, and in mortgages for principal-dwelling houses of €157 million. Data from the Irish Banking Federation (IBF) for the second quarter of 2009 also confirm the slowdown in activity in the housing market. While the number of mortgage drawdowns was higher in the second quarter of 2009, compared with the first, the value of mortgage drawdowns in Q2 2009 was just one third of the value drawn down in the second quarter of 2008.

Sectoral data for the second quarter of 2009 show that fourteen out of fifteen economic sectors experienced lower annual growth rates than during the same quarter in 2008. Lending to the real estate and construction sectors had been driving credit growth during the period 2006-2007, but the annual rate of increase of lending to real estate fell from a high of 65.5 per cent in Q2 2006, to just 1.7 per cent in Q2 2009. Nine economic sectors had negative annual rates of change in the second quarter of 2009. The continued dominance of the financial intermediation sector was evident in the June data. The annual rate of increase in lending to this sector was 17.3 per cent in the second quarter of 2009. Annual growth rates in the other 14 sectors ranged from minus 33.3 per cent in manufacturing to plus 19 per cent in education. PSC comprises two main elements — loans and holdings of securities. Financial intermediation accounts for one-fifth of outstanding PSC, and holdings of securities account for most of the increase in financial intermediation. This largely arises from internal securitisations by credit institutions, where credit institutions repurchase the asset-backed securities they issue through SPVs for use as collateral in ECB refinancing operations.

Credit to non-property business sectors fell by 6.2 per cent in the second quarter of 2009. These sectors' share of PSC has been gradually declining over the last twelve months, accounting for 11.6 per cent at the end of the second quarter of 2009, compared to 12.7 per cent a year earlier. Outstanding credit to these sectors declined by €4.1 billion over the quarter, to reach €49 billion.

Domestic Lending and Deposit Rates

Interest rates for households and NFCs have changed little since May, when the ECB last cut the main refinancing operations rate. Against the background of falling Euribor rates, however, margins between inter-bank and retail lending rates widened, reversing much of the narrowing that had occurred between the beginning of the year and the May rate cut.

Table 2: Sectoral Breakdown of Private-Sector Credit[a]

	Total stock at end-June 2009		Change in credit			
			Q-on-Q		Y-on-Y	
	€ million	% share	€ million	% change[a]	€ million	% change[a]
Primary industries[b]	6,163	1.5	–255	–4.0	–119	–1.9
Manufacturing	7,821	1.9	–750	–8.8	–1,359	–14.8
Electricity, gas and water supply	1,015	0.2	–236	–18.8	–126	–11.0
Construction	19,002	4.5	–2,283	–10.7	–5,686	–23.0
Wholesale/retail trade and repairs	13,236	3.1	–817	–5.8	–519	–3.8
Hotels and restaurants	11,295	2.7	–141	–1.2	–950	–7.8
Transport, storage and communications	3,283	0.8	–65	–1.9	–41	–1.2
Financial intermediation	86,181	20.5	17	0.0	12,716	17.3
Real estate activities	89,401	21.2	571	0.6	1,493	1.7
Business activities	6,161	1.5	–996	–13.9	–971	–13.6
Services to households	6,386	1.5	–121	–1.9	–30	–0.5
Personal	170,935	40.6	–352	–0.2	70	0.0
of which:						
– Residential mortgages	148,348	35.2	17	0.0	3,007	2.1
– Other housing finance	718	0.2	–181	–20.2	–435	–37.8
– Other	21,869	5.2	–187	–0.8	–2,502	–10.3
Total	**420,879**	**100.0**	**–5,426**	**–1.3**	**4,478**	**1.1**
Total PSC (Table A2.2, Monthly Statistics)	*387,350*		*–4,908*	*–1.3*	*–5,587*	*–1.4*

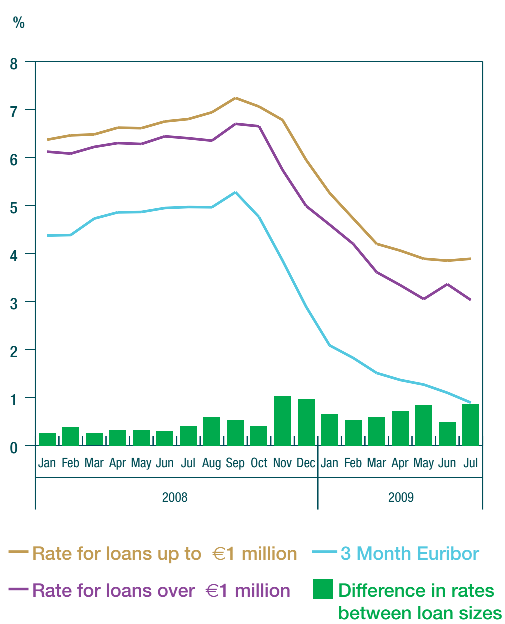
[a] The Total figure in Table 2 includes securitised residential mortgages which have been added back into lending to the Personal sector to give a more accurate figure for personal borrowing. Some of the mortgage-backed securities created with these loans have been purchased by Irish credit institutions and would also be included under Financial Intermediation above. As such there is an element of double-counting in the Total figure. The official level of PSC outstanding (inclusive of accrued interest) is reported in Table A2.2 of the Statistical Appendix and is shown in the last row of Table 2 above, along with the unadjusted quarterly and annual changes in PSC. The adjusted growth rates for total PSC (which account for exchange-rate valuation effects and lending to non-bank IFSC companies), mortgage and non-mortgage credit are available from Table A2.2 of the CBFSAI Monthly Statistics.

[b] Primary industries refer to agriculture, forestry, fishing, and mining and quarrying.

Source: CBFSAI. Data are based on NACE Rev. 1 industrial codes. For earlier data see Table C8 of the Statistical Appendix.

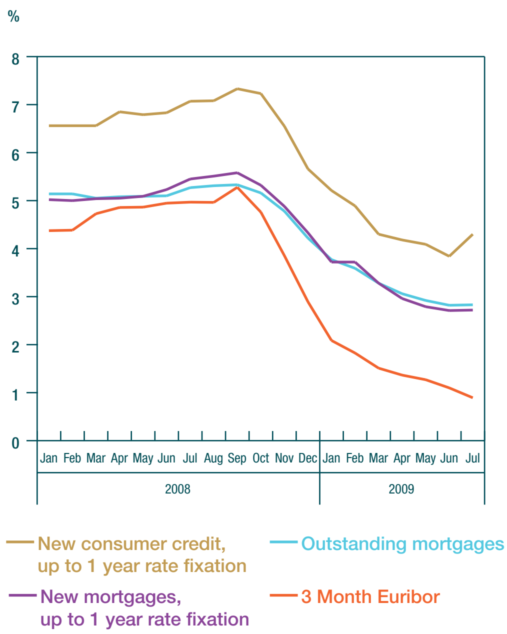
The changes in short-term Euribor rates in June are evident in rates for NFC loans, which are often linked explicitly to inter-bank rates. New short-term or variable-rate loans of over €1 million rose by 31 basis points during June, and then fell by 33 points in July. This was in line with developments at euro-area level. NFC loan rates for loans under €1 million, which are slower to respond to inter-bank rate changes, are unchanged since May. NFC loans under €1 million can be used as a proxy for lending to smaller companies. Overall, rates for loans under €1 million are 3.4 percentage points lower, while rates for loans over €1 million are 3.7 percentage points lower than before the beginning of the rate-cutting cycle. This compares to cuts totalling 3.25 percentage points in the main refinancing rate. The gap between rates for smaller and larger loans is at the highest level this year, at around 0.9 percentage points. A similar pattern is evident across the euro area. This would also be in line with results from the latest BLS (Q2 2009), where banks reported that the transition to Basel II had a strong impact on credit standards for lending to small and medium sized enterprises.

Chart 10: New NFC Loans with Floating Rate and up to One-Year Initial Rate Fixation



Source: CBFSAI.

Chart 11: Lending Rates to Households



Source: CBFSAI.

Average rates for both new variable-rate mortgage customers and existing mortgage holders fell by 8 and 10 basis points, respectively, between May and June. However, both increased marginally, by two basis points in July — the first month-on-month increases since September 2008. The margin between new variable-mortgage rates and the ECB rate has remained in the region of 1.7 percentage points since the beginning of the year, which compares to a margin of around 1 percentage point at the beginning of 2008. The extent to which the new and existing mortgage rates have moved together gives an indication of the high proportion of variable-rate mortgages in banks' outstanding loan books. Ireland has among the lowest average interest rates for outstanding mortgages in the euro area, and has experienced one of the sharpest declines in rates since September 2008.

Overnight and redeemable at notice deposit rates have remained broadly steady since May. Interest on agreed maturity deposits declined, however, by 16 basis points for new household customers and 26 basis points for new NFC customers over the period. As the spread between interest payable on time deposits compared to overnight or redeemable at notice has narrowed, there has been a shift out of time deposits, with new business deposits with agreed maturity for households falling by over €2 billion between May and July. Conversely, the volume of overnight deposits and deposits redeemable at notice for households increased by over €1.6 billion in the same period. Outstanding agreed maturity deposit rates have remained high, reflecting the competition for such deposits during end-2008 and early-2009.

Table 3: Deposit Rates to Households and Non-Financial Corporations[a]

%	2009					
	Feb.	Mar.	Apr.	May	June	July
DEPOSITS						
Households						
— Overnight[b]	0.79	0.64	0.66	0.61	0.56	0.59
— With agreed maturity	2.01	1.84	1.74	1.64	1.61	1.48
— Redeemable at notice[b]	2.80	2.50	2.45	2.29	2.32	2.29
Non-financial corporations						
— Overnight[b]	0.53	0.40	0.40	0.37	0.30	0.36
— With agreed maturity	1.86	1.61	1.45	1.48	1.38	1.22

[a] Rates are for new business.
[b] For these categories, new business is defined as outstanding amounts.
Source: CBFSAI.