AIB Global Treasury
Economic Research

EXCHANGE RATE MONTHLY

August/September 2005

Dollar Loses Some of Its Appeal

- Factors supporting the dollar seems to have lost their appeal as markets discount US interest rate increases. The outlook for the eurozone also appears more optimistic, providing a boost to the euro.

- Sterling has recovered well from recent lows as markets pare back expectations for UK rate cuts. However, the outlook on rates remains very finely balanced and much will depend on the trend in forthcoming data.

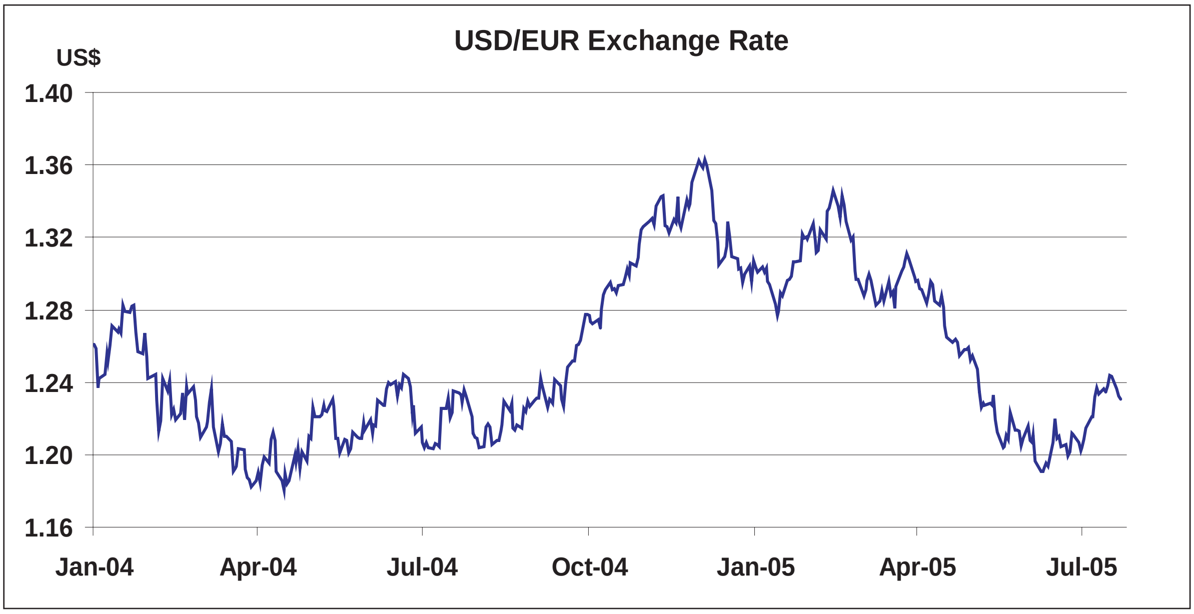
- After a period of weakness, the outlook for the yen has become more positive. A number of factors, including an improvement in Japanese economic conditions, suggest further strength versus the dollar going forward.

John Beggs
Chief Economist

Oliver Mangan
Chief Bond Economist

Geraldine Concagh
Senior Economist

Jenny Pollock
Senior Economist



Summary of Forecasts

Exchange Rates

Euro Versus		Forecast Range Over The Period			
	Current	**Q3 - 2005**	**Q4 - 2005**	**Q1 - 2006**	**Q2 - 2006**
USD	1.2259	1.20-1.25	1.20-1.25	1.22-1.27	1.22-1.27
GBP	0.6784	0.67-0.69	0.67-0.69	0.67-0.69	0.67-0.69
JPY	135.09	132-137	130-135	130-135	130-135
PLN	4.0158	4.10	4.05	4.05	4.05

Dollar Versus		Forecast Range Over The Period			
	Current	**Q3 - 2005**	**Q4 - 2005**	**Q1 - 2006**	**Q2 - 2006**
JPY	110.19	107-112	105-110	103-108	103-108
GBP	1.8070	1.78-1.83	1.78-1.83	1.82-1.87	1.82-1.87
CHF	1.2623	1.27	1.27	1.25	1.25
AUD	0.7576	0.76	0.76	0.78	0.78

Official Interest Rates

		Forecast to End Period			
	Current	**Q3 - 2005**	**Q4 - 2005**	**Q1 - 2006**	**Q2 - 2006**
Euro Refi Rate	2.00	2.00	2.00	2.00	2.00
US Fed Funds	3.25	3.75	4.00	4.25	4.50
UK Base Rate	4.75	4.50	4.25	4.25	4.25
Japan ODR	0.10	0.10	0.10	0.10	0.10

Growth and Inflation

		GDP			**Inflation**	
Y-on-Y% Change	**2004**	**2005**	**2006**	**2004**	**2005**	**2006**
US	4.4	3.7	3.6	2.7	2.8	2.5
Eurozone	2.0	1.3	1.8	2.1	2.1	1.9
UK	3.1	1.7	2.4	1.3	2.0	2.0
Japan	2.6	1.9	2.2	-0.2	-0.3	0.1
Ireland	4.5	5.0	5.5	2.2	2.3	2.6

Our View In Brief

* **Oil prices are dominating headlines with prices averaging $53 per barrel year to date, 60% above the average price for 2004. Markets are closely watching for signs of extended inflationary impacts in the main economies, though there are also growing concerns about the longer term negative implications for consumption and investment.**

* **The US economy grew by an annualised 3.4% in Q2, indicating that the upswing in activity remains strong. For the remainder of the year the economy should expand at a pace of between 3.5-4.0%, with consumer spending and investment continuing to grow. Inflation in the US has also picked up, reflecting higher energy costs. Against this background, the Fed continues to increase US interest rates at a measured pace. We continue to expect the Fed funds rate to be at 4.00% by year end, before rising by a further 0.50% to 4.5% during 2006.**

* **Talk of higher US rates and a relatively better economic performance are still providing some support for the dollar versus the euro but the significance of these factors has started to diminish with US rate hikes almost fully priced in and the outlook for Europe starting to improve. There are also renewed concerns about large US external imbalances, with the trade deficit widening as high oil prices hit import costs.**

* Initial estimates show that the eurozone economy grew by just 0.3% in the second three months of the year, a marked slowdown from Q1's growth rate of 0.5%. The slowdown was largely due to a stagnation in the German economy. Growth does seem likely to improve in Q3, with business sentiment surveys recording a pick-up in confidence in June and July. However, even if activity strengthens again in H2, GDP growth should still average less than 1.5% in 2005.

* **Official interest rates in the eurozone have been on hold since June 2003. With the economy losing momentum in Q2, there had been some speculation that the ECB could move to cut rates. However, given the recent pick-up in some leading indicators the market now believes that rates will remain unchanged, unless there is a renewed deterioration on the growth front or inflation falls well below 2.0%.**

* After a very strong performance in Q1 (GDP growth of 5.4% annualised), the Japanese economy slowed down in Q2, with GDP growing by an annualised 1.1% in the April-June period. The downturn, however, was overstated by an inventory correction. Private capital spending and consumption remain strong, suggesting that a sustained recovery in domestic demand is underway. Meanwhile, there are signs that deflationary pressures are finally easing.

* Growth in the UK economy was well below trend in H1, reflecting a slowdown in consumer demand and weakness in the manufacturing sector. Recent trends, as well as July's terrorist attacks, suggest that the economy is unlikely to recover until near the year end. The BoE cut interest rates at its policy meeting in August. The outlook for rates going forward is very finely balanced and will depend on the trend in forthcoming data on the housing market and consumer demand, as well as inflation.

* **Sterling has recovered well from the levels seen in July when markets were speculating that UK rates could be cut by up to 0.75%. It could fall back again in the weeks ahead if key data confirm the case for another rate cut. However, selling against the dollar is unlikely to be anyway as aggressive as that seen earlier, with the dollar losing some of its appeal of late and the market less forceful in its outlook for UK interest rates.**

18 August 2005

Interest Rate Environment

US Interest Rates Continue to Rise

* As expected, the Fed raised US interest rates by a further 0.25% at its policy meeting in August, bringing the Fed funds rate to 3.50%. Since June of last year, rates in the US have been raised by 2.50%.

* The tone of the Fed's statement suggests that it will continue to tighten monetary policy over the coming months. We see the Fed funds rate rising by another 0.50% to 4.0% by year end.

* High oil prices and some concerns about consumer spending have seen US bond yields drop back from early August peaks. We still anticipate, though, that yields will resume their uptrend over the balance of the year.

US Interest Rates

	Current	Sept 05	Dec 05	Mar 06
Fed Funds	3.50	3.75	4.00	4.25
3 Month	3.81	3.90	4.15	4.40
1 Year	4.26	4.30	4.40	4.60
2 Year*	4.40	4.45	4.60	4.80
5 Year*	4.52	4.60	4.80	4.90
10 Year*	4.65	4.75	4.95	5.05

** Swap Forecasts Beyond 1 Year*

ECB Rates to Stay on Hold

* Interest rates in the eurozone have been at 2.0% since June 2003. With the eurozone economy losing momentum in Q2, there had been growing pressure for a rate cut.

* More recent data releases, however, suggest that the economic outlook is improving, though it is early days yet. Thus, we anticipate that the ECB will leave rates on hold for an extended period. We do not expect to see policy tightening until H2-2006 at the earliest.

* Eurozone yields have also dropped back in line with Treasuries. Some upward movement is anticipated later in the year. The rise in yields, though, should be modest, given the relative weakness in the eurozone economy.

Eurozone Interest Rates

	Current	Sept 05	Dec 05	Mar 06
Refi Rate	2.00	2.00	2.00	2.00
3 Month	2.13	2.15	2.15	2.15
1 Year	2.20	2.25	2.30	2.40
2 Year*	2.34	2.45	2.55	2.65
5 Year*	2.78	2.90	3.00	3.10
10 Year*	3.32	3.45	3.55	3.65

** Swap Forecasts Beyond 1 Year*

Outlook For UK Rates Finely Balanced

* The Bank of England cut UK interest rates by 0.25% in August, bringing base rates to 4.50%. This came as no great surprise given the recent downturn in the housing market and consumer spending.

* The market is currently discounting some possibility of one more rate cut before year end, with any move likely in either October or November. However, the outlook has become more finely balanced following the release of recent strong inflation data. The BoE has also signalled that it is in no hurry to cut rates again, given the potential inflationary threat from higher oil prices.

UK Interest Rates

	Current	Sept 05	Dec 05	Mar 06
Repo Rate	4.50	4.50	4.25	4.25
3 Month	4.56	4.35	4.30	4.30
1 Year	4.39	4.35	4.40	4.45
2 Year*	4.50	4.50	4.60	4.70
5 Year*	4.55	4.60	4.70	4.80
10 Year*	4.58	4.70	4.80	4.90

** Swap Forecasts Beyond 1 Year*

Exchange Rate Outlook

KEY ISSUES

- ***Dollars Interest Rate Support Fades:*** Year to date the dollar is still up some 9% against the euro but upside momentum has faded as markets focus once again on the US trade deficit.
- ***Sterling Bounces Back:*** Sterling has recovered considerable ground against the dollar and euro as markets pare back expectations for UK rate cuts.
- ***Outlook for Yen Improves:*** A number of factors, including an improvement in Japanese economic conditions, suggest yen strength versus the dollar going forward.

Dollar Slips as US Rate Hikes Are Well Discounted

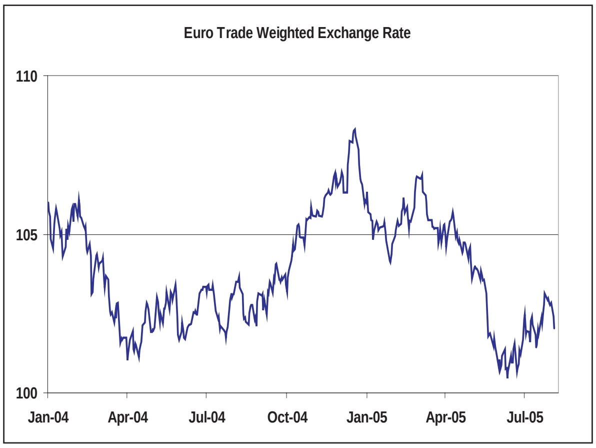
The rally experienced by the dollar over Q2 was supported by four main factors; expectations for higher US interest rates, signs of an improvement on US structural imbalances, political and economic uncertainty in Europe and speculation of dollar supportive flows relating to the Homeland Investment Act. As we had anticipated, support from these factors is fading with the euro bottoming out at $1.1869 in early July.

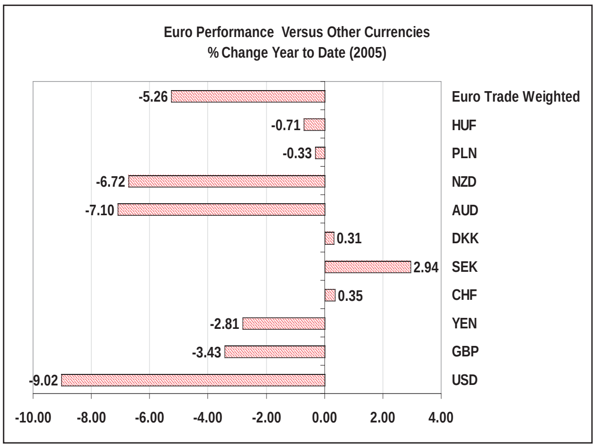
Over the past month, dollar/euro has traded in a five cent range centred around $1.22, with much of the activity in the euro's favour. With rate hikes in the US becoming more fully discounted (the market expects US rates to peak in mid 2006), the dollar has become generally unresponsive to strong US economic data.

A brighter outlook for the eurozone economy has also hit dollar sentiment. Expectations for the eurozone economy had been particularly gloomy, leaving room for upside surprises as seen in recent data releases. As a result, the market no longer expects the ECB to cut eurozone interest rates.

IMM positions data show that the market went net long of euros for the first time since May in the week ending 9 August, highlighting the improvement in sentiment levels. However, there is still some way to go before investors becomes broadly neutral on the dollar. This could pave the way for continued dollar selling, as investors continue to cut back on their dollar exposure. Talk of dollar diversification by other central banks after recent policy changes by the Russian monetary authorities has also prompted some dollar selling.

With attention sidetracked from US interest rates, structural imbalances also seem to be coming back to haunt the dollar. Faster economic growth is contributing to a substantial narrowing of the government budget deficit. However, the trade deficit continues to trend upwards as higher oil prices make their presence felt.





The deficit in goods and services rose to $58.8 billion in June, from a slightly revised $55.4 billion deficit for May. Higher crude oil prices could continue to be reflected in the trade deficit in the coming months, which would impact on the dollar, particularly if net capital inflows data disappoint.

While the interest rate and growth environment in the US should be broadly dollar supportive, upside potential may well be constrained unless markets turn more aggressive in their outlook for US monetary policy or the trade deficit starts to improve again. However, this is unlikely to happen in the near-term. We anticipate a $1.20-1.25 trading range over the short-term.

Sterling Recovers As BoE Cautious On Inflation Outlook

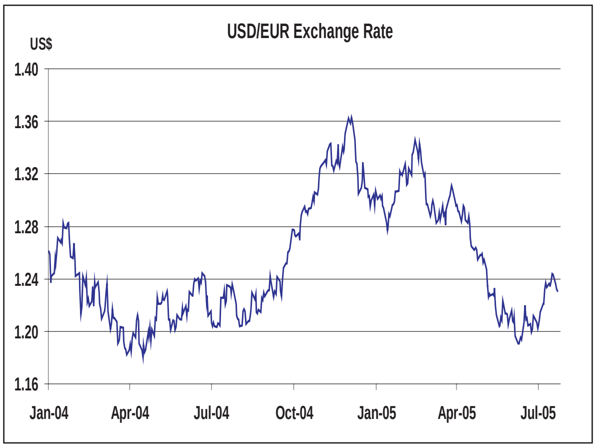
Sterling has recovered well from the levels seen in July when it was trading at a two year low versus the dollar and its lowest level against the euro since August 2004. July's sell-off was triggered by expectations that the BoE would move to cut UK interest rates in response to weakening domestic demand.

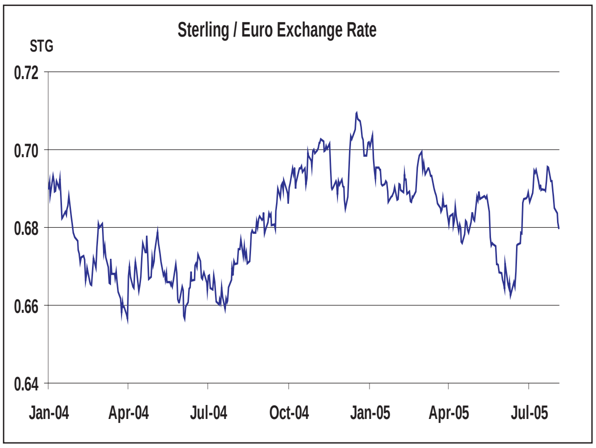
The MPC did indeed cut rates at its policy meeting in August. This came as no great surprise given the recent downturn in the housing market and consumer spending. Activity data released since then, however, have been less alarming. Furthermore, UK inflation has moved to a nine year high as rising oil prices impact. This has caused markets to pare back expectations for further interest rate cuts, prompting a relief rally in sterling.

Interest rate markets still see some possibility of one more rate cut before year end, though the certainty surrounding such a move seems to be diminishing quickly. Given the expectation for US interest rates (4.0% by year end) this would leave the US/UK interest rate differential at 0.25%, its lowest level since 2001, which could be negative for sterling, particularly against the dollar.

While another cut is indeed still possible, the BoE's recent Quarterly Inflation Report suggests that the MPC is in no hurry to ease monetary policy again. Notably, the report expressed concerns about the possible inflationary impact of higher oil prices. Recent inflation data are likely to reinforce these concerns, with the annual headline CPI rate now well above the 2.0% target level. Furthermore, the minutes of the August meeting showed only five MPC members voting for the rate cut and, more importantly, the Governor voting against the move.

This leaves the outlook on rates very finely balanced. Forex markets will be closely watching the trend in forthcoming data on housing and consumer demand for clues on the likely direction of rates, as well as inflation numbers.





Sterling could fall back again in the weeks ahead if these key data confirm the case for another rate cut. However, selling against the dollar is unlikely to be anyway as aggressive as that seen in July, with the dollar losing some of its appeal of late and the market less forceful in its outlook for lower UK interest rates. This should also limit downside against the euro.

Thus, in the short-term cable could remain in a $1.78-1.83 range. Over the longer-term we would expect cable to settle back into a $1.82-1.87 range as UK rates bottom out and the economy returns to trend growth. Meanwhile, sterling/euro looks to have returned to a $0.67-0.69 range.

Outlook Turns More Positive for Yen

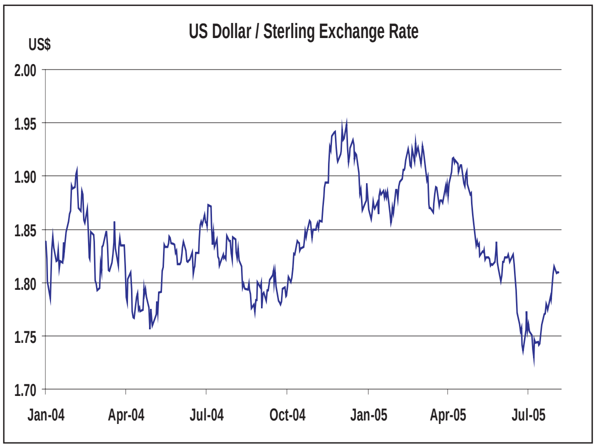
After a period of weakness driven by a generally stronger dollar, political uncertainty, concerns about the impact of high oil prices (reflected in a fall in the current account surplus) and an underperforming equity market, the outlook for the yen has become more positive, with dollar/yen moving back to around Y110.

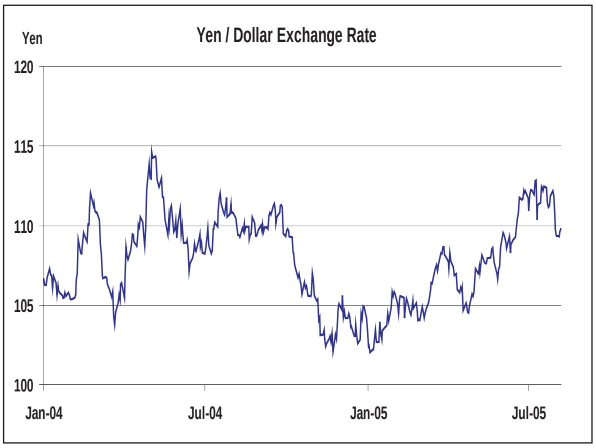
The recent revaluation of the Chinese yuan has also lifted the yen. While this could offer some underlying support going forward it is unlikely to be a major factor as China is expected to keep a tight rein on any movement in the yuan. A number of other factors, however, suggest further strength versus the dollar going forward.

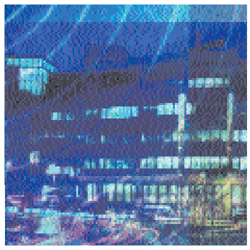
Economic conditions in Japan are improving, particularly on the domestic front, which should compensate for any weakness on the export side. Furthermore, although the CPI is still falling slightly y-on-y, there are continuing signs that deflationary pressures, which have plagued the economy for the past six years, are easing. This improvement in the economic environment is reflected in Tokyo stocks, which are currently trading around four year highs.

Parliament's decision to reject legislation aimed at privatising Japan's postal service resulted in a snap election being called for 11 September. While political uncertainty could have some negative impact in the near term, the outcome of the election is unlikely to unduly affect the reform progress and the yen and Japanese markets should recover in due course. Furthermore, market data show that speculators are still well long the dollar versus the yen, suggesting room for further correction.

Thus, while dollar/ yen could trade in a Y107-112 range until the election is out of the way, we expect to see further yen appreciation over the longer term as political risk unwinds and markets focus on encouraging fundamental factors.







KEY MARKET EVENTS

Week 1	**August 23**	**GER**	**ZEW Index (August)**
(22 - 26 August)	**August 25**	**GER**	**Ifo Business Survey (August)**
	August 26	**UK**	**GDP - 2nd Estimate (Q2)**
Week 2	**August 30**	**US**	**Consumer Confidence (August)**
(29 Aug - 2 Sept)		**US**	**FOMC Minutes (9 August Meeting)**
	August 31	**Eurozone**	**HICP Flash Estimate (August)**
		US	**GDP - 2nd Estimate (Q2)**
	September 1	**US/UK/EU**	**Manufacturing PMI/ISM (August)**
		US	**Personal Income & Consumption (July)**
		Eurozone	**ECB Policy Announcement and Press Conference**
	September 2	**US**	**Non-Farm Payrolls (August)**
Week 3	**September 5**	**UK/EU**	**Services PMI (August)**
(5 - 9 Sept)	**September 6**	**US**	**Services ISM (August)**
	September 7	**US**	**Fed Beige Book**
	September 8	**Eurozone**	**ECB Monthly Bulletin (September)**
		UK	**Monetary Policy Announcement**
Week 4	**September 11**	**Japan**	**Parliamentary Election**
(12 - 16 Sept)	**September 12**	**UK**	**Producer Prices (August)**
	September 13	**UK**	**Consumer Prices (August)**
		US	**Producer Prices (August)**
	September 14	**US**	**Retail Sales (August)**
	September 15	**UK**	**Retail Sales (August)**
		US	**Consumer Prices & Industrial Production (August)**
	September 16	**US**	**Current Account Balance (Q2)**
		US	**Net Capital Inflows (TICS) (July)**

AIB International Centre, IFSC, Dublin 1 Tel: 353-1-8740222 Fax: 353-1-6799590