

EXCHANGE RATE MONTHLY

July/August 2005

AIB Global
Treasury
Economic
Research

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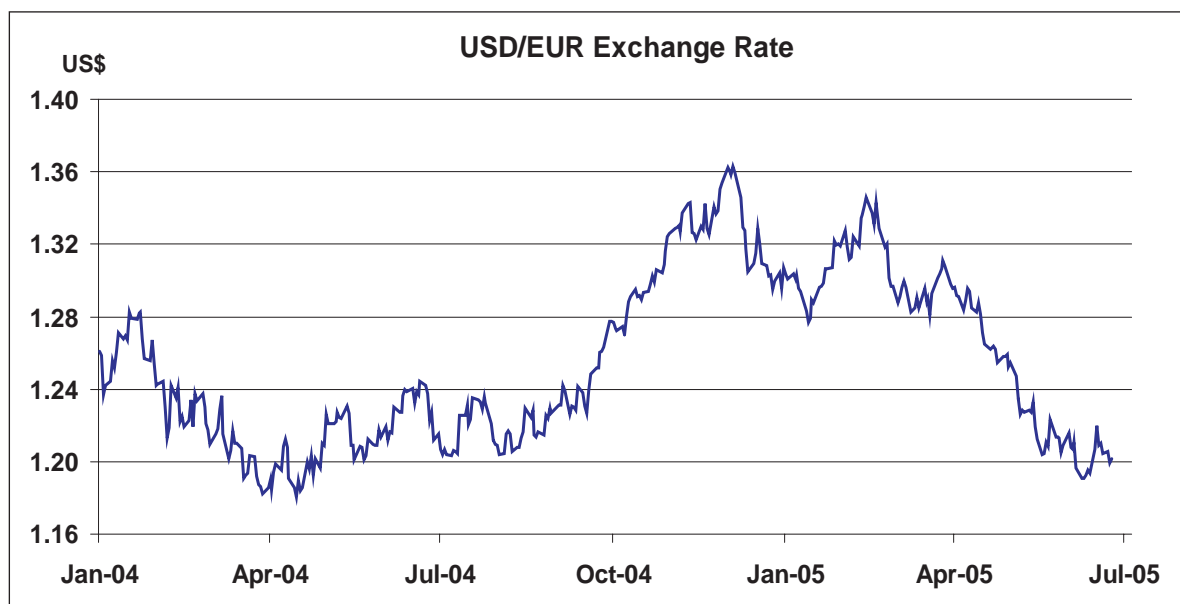
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Interest Rate Outlook Keeps Dollar Strong

- China has finally revalued the yuan. The 2% adjustment was less than expected, thus limiting the impact on forex markets. However, the new regime facilitates further adjustment ahead.
- The outlook for monetary policy continues to be the main driving force in forex markets. With markets predicting a rise to 4% for US interest rates by end 2005, dollar strength should continue for now. However, the longer-term outlook is more uncertain.
- Sterling has been badly hit by the slowdown in the UK economy. Further weakness is predicted near-term with UK interest rate cuts in the pipeline. The first cut is expected on 4 August.



Summary of Forecasts

Exchange Rates

Euro Versus		Forecast Range Over The Period			
	Current	Q3 - 2005	Q4 - 2005	Q1 - 2006	Q2 - 2006
USD	1.2174	1.18-1.23	1.20-1.25	1.22-1.27	1.22-1.27
GBP	0.6942	0.69-0.71	0.68-0.70	0.68-0.70	0.68-0.70
JPY	134.93	132-137	130-135	130-135	130-135
PLN	4.10	4.10	4.10	4.05	4.05

Dollar Versus		Forecast Range Over The Period			
	Current	Q3 - 2005	Q4 - 2005	Q1 - 2006	Q2 - 2006
JPY	110.80	109-115	105-110	105-110	105-110
GBP	1.753	1.70-1.75	1.74-1.79	1.78-1.83	1.78-1.83
CHF	1.28	1.29	1.27	1.25	1.25
AUD	0.76	0.76	0.76	0.78	0.78

Official Interest Rates

	Current	Forecast to End Period			
		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

Y-on-Y% Change	GDP			Inflation		
	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	1.9	1.8
Japan	2.6	1.7	2.0	-0.2	-0.3	0.1
Ireland	4.9	6.0	6.5	2.2	2.2	2.6

Our View In Brief

- * In a long-awaited move, China has abandoned its currency peg with the US dollar. The yuan will now float against a basket of currencies which includes the dollar. Within this basket, the yuan has initially been set at a rate of 8.11 to the dollar, which represents a 2.1% revaluation on its previous peg. The size of the revaluation was well below the 10% anticipated, limiting market reaction. The impact on trade flows and hence on the US current account deficit should also be minimal. Nonetheless, the mechanics of the new regime facilitates further change, prompting speculation that is a transitional move with further incremental adjustments possible in the months ahead.
- * Global economic conditions remain mixed. While the US economy is achieving above trend growth and a rebound in activity in Japan appears to be in place, there is a distinct lack of momentum in European economies, suggesting a mixed performance from the world economy in 2005.
- * The US economy grew by an annualised 3.8% in Q1, indicating that the upswing in activity continues, despite some evidence of a softening in the manufacturing sector. The economy is expected to register strong growth again in Q2, with GDP growth forecast to be in the region of 3.5%. We expect GDP growth of 3.7% in the US in 2005 and 3.6% in 2006. Against this background, the Fed continues to increase US interest rates at a measured pace. We now 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.
- * The Chinese revaluation may take some pressure off the euro versus the dollar. However, talk of higher US rates and a relatively better economic performance should ensure that dollar sentiment remains bullish over the coming weeks, keeping the euro on the backfoot. Longer term, though, the continuing large US external imbalances could trigger another bout of dollar weakness.
- * The eurozone economy grew by 0.5% in the first three months of the year. Most leading indicators and activity data show that growth should fall back again in Q2, with domestic demand remaining subdued. 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 has been some speculation that the ECB may move to cut rates. However, the market now believes that rates will remain unchanged, unless there is a further deterioration on the growth front or inflation falls well below 2.0%.
- * The Japanese economy bounced back strongly in Q1 2005, growing by an annualised rate of 4.9%. It was particularly encouraging to see that the pick-up in activity was entirely due to domestic factors. It remains to be seen, though, whether or not Japan is in the midst of a domestic economic recovery.
- * 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, increasing the pressure on the BoE to cut interest rates. We now expect UK rates to be at 4.25% by year end.
- * There has been a marked turn in sterling sentiment of late as markets anticipate an easing in UK monetary policy. We expect the UK currency to remain vulnerable over the coming months as it unwinds the interest rate premium it has been carrying since 2003.

22 July 2005

Interest Rate Environment

Fed Stays on Tightening Path

- * As expected, the Fed raised US interest rates by a further 0.25% at its policy meeting in June, bringing the Fed funds rate to 3.25%. Since June of last year, rates in the US have been raised by 2.25%.
- * Recent comments from the Fed suggest that it will continue to tighten monetary policy over the coming months. We see the Fed funds rate rising by another 0.75% to 4.0% by year end.
- * As markets reassess the outlook for US interest rates, bond yields have picked up a little of late. We anticipate a further rise in yields in the second half of the year.

US Interest Rates				
	Current	Sept 05	Dec 05	Mar 06
Fed Funds	3.25	3.75	4.00	4.25
3 Month	3.61	3.90	4.15	4.40
1 Year	4.06	4.25	4.40	4.60
2 Year*	4.22	4.40	4.60	4.80
5 Year*	4.40	4.60	4.80	4.90
10 Year*	4.58	4.75	4.95	5.05
* Swap Forecasts Beyond 1 Year				

ECB Rejects Pressure for Lower Rates

- * Interest rates in the eurozone have been at 2.0% since June 2003. With the eurozone economy losing momentum, there has been growing pressure for a rate cut.
- * While an easing in monetary policy cannot be ruled out, in our view, inflation would need to fall well below 2% or the economy weaken even further before the ECB would move to ease policy. 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 moved higher in the past month in line with Treasuries. Some further upward movement is anticipated later in the year in line with US markets. The rise in yields, though, should be modest, given the 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	2.09	2.10	2.10	2.10
1 Year	2.14	2.20	2.30	2.40
2 Year*	2.34	2.45	2.55	2.65
5 Year*	2.80	2.90	3.00	3.10
10 Year*	3.36	3.45	3.55	3.65
* Swap Forecasts Beyond 1 Year				

Outlook For UK Rates Changes

- * Revisions to national accounts show that the UK economy grew by just 0.4% in Q1 2005. Activity remained weak over Q2, with the economy growing by another below trend 0.4%. Thus, after leaving interest rates on hold since August of last year, the BoE is now expected to ease monetary policy over the coming months.
- * We look for the MPC to sanction a 0.25% rate cut in August. A further 0.25% cut is possible in September or October as the impact of the London bombings becomes evident in economic data.

UK Interest Rates				
	Current	Sept 05	Dec 05	Mar 06
Repo Rate	4.75	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*	4.41	4.40	4.50	4.60
5 Year*	4.51	4.60	4.70	4.80
10 Year*	4.62	4.70	4.80	4.90
* Swap Forecasts Beyond 1 Year				

Exchange Rate Outlook

KEY ISSUES

- **Dollar Sentiment Remains Strong:** Year to date the dollar is up some 12% against the euro as ongoing evidence of solid US economic growth and continued action from the Fed underpin sentiment.
- **Euro To Stay Weak Near-Term:** We expect the euro to stay weak near-term, as markets focus on the outlook for US interest rates. However, longer-term there is scope for a modest recovery.
- **Sterling To Stay Weak Versus Euro:** Sterling has come under sharp downward pressure against both the dollar and euro as markets price in UK rates cuts.

US Interest Rate Prospects Keep Dollar Strong

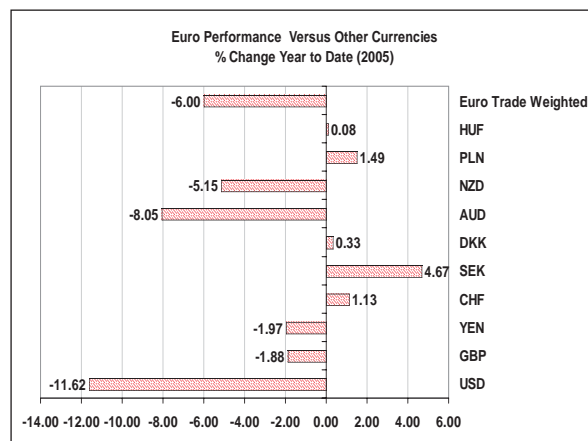
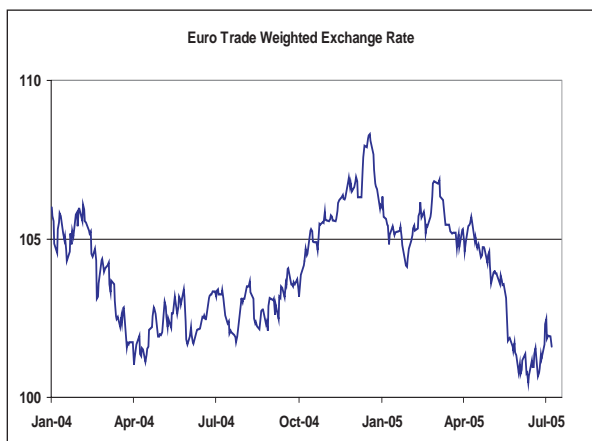
Although the revaluation of the Chinese yuan is currently dominating headlines, prospects for monetary policy in the US and Europe continue to be the major driving force for forex markets. The euro hit a 14-month low of \$1.1869 versus the dollar in early July as traders bet that the ECB would cut interest rates in response to persistent weakness in the eurozone economy.

However, it has since steadied, with the ECB insisting that it will not be easing monetary policy. Moreover, recent eurozone data have tended to come in on the better side of expectations. As a result, interest rate futures are now showing that, instead of anticipating a cut in rates by year end, markets now expect steady policy into 2006. Concerns about eurozone politics have eased of late, with the revaluation in the yuan also taking some pressure off the euro.

The dollar, however, retains the upper hand, with the Federal Reserve expected to increase US interest rates to 4.0% by year end. Even if eurozone rates do remain on hold this would give the dollar a 2% interest rate advantage. Thus, given the current focus on interest rate trends, we expect the euro to stay weak in the near-term, with a dip back below \$1.20 still more likely than a return to \$1.25 territory.

As well as interest rate differentials, the dollar is being supported by growing evidence that the US structural imbalances (fiscal and trade imbalances) are improving. After reaching a record high level of \$60.1bn in February, the trade deficit fell back to \$55.3bn in May.

There has also been a marked improvement in the Treasury budget balance. Over the first nine months of fiscal year 2005 the federal government has run a cumulative deficit of \$250 billion, down 24% from the same point last year. Very strong growth in tax revenues is the major reason for the smaller deficit.



Furthermore, the White House has revised down its deficit forecast for fiscal year 2005 and 2006. Meanwhile, net capital inflows disappointed in March and April but bounced back in May.

The dollar's rally year to date has left many asking the question whether, after three years of decline, it has turned the corner or could we even be on the cusp of a new uptrend. Underpinned by interest rate expectations, an easing in concerns about external imbalances plus temporary capital flows associated with the Homeland Investment Act (as discussed in last month's Exchange Rate Monthly), dollar support will remain in place over the summer months.

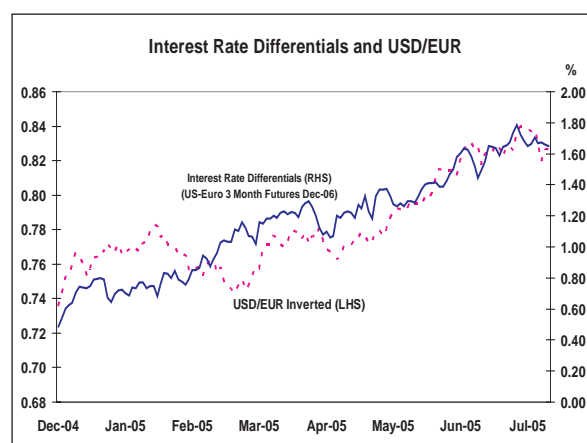
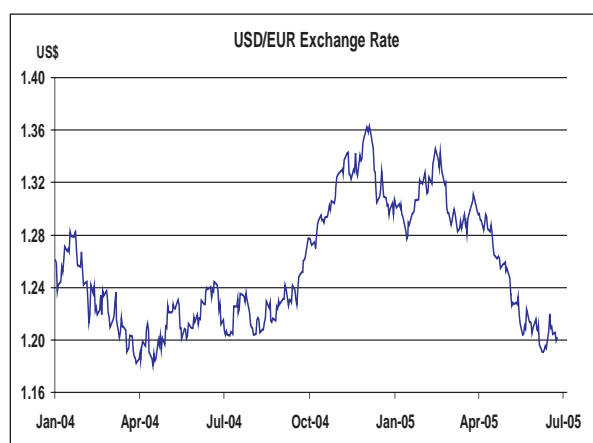
The point at which the market perceives that US rates have peaked could be crucial for the dollar. It is currently looking for Fed funds to peak at 4.00% by year end and as such dollar support from rising rates could well fade over Q4. There are signs that the market is beginning to discount a further 0.25% rise in 2006. However, ECB rate hikes should also be anticipated at this point.

The improvement in the current account deficit could also prove to be temporary. Higher oil prices in June and July should push the trade gap back up again. Recent gains in the dollar could also impact on the export side and concerns about external imbalances may well re-emerge over the longer term. Furthermore, the token revaluation in the Chinese yuan is unlikely to impact on trade flows. Thus, we still see some scope for a modest rebound in the euro back towards \$1.25 over the final quarter and into 2006. In the meantime, however, we would view any bounces towards the \$1.23 level as good value for dollar buyers.

Tidal Wave of Bad News Hits Sterling

On 23 June sterling was trading at a ten month high of Stg66.5p against the euro. Since then there has been a marked deterioration in sentiment, with sterling/euro now trading around the Stg69.5p level, a fall of some 4.5% over the period. The current sell-off was triggered by the release of major revisions to UK national accounts data, which resulted in the annual growth rate for Q1 being lowered from 2.7% to 2.1%. This was a key turning point for sterling with the fall to below trend growth sharply increasing the odds of a UK rate cut before the end of the summer.

Data released over recent weeks, as well as the terrorist attacks on 7 and 21 July, have further cemented expectations that the Bank of England will have little option but to move to ease monetary policy. Manufacturing remains in the doldrums but of greater concern is the fact that there has been a marked slowdown in the services sector, which has been the mainstay of the UK economy for sometime now. House prices continue to decline, consumer confidence is at a six month low



and there has been a marked deceleration in the rate of retail spending. Falls against the dollar have also been quite large, with sterling beaten back by the comparative outlook for US and UK interest rates. From its high point of the year, (\$1.9325 on 8 March) sterling/dollar hit a low of \$1.7273 in late July, a drop of almost 11% and its lowest level for nearly 2 years.

The relatively strong performance by the UK economy over recent years and higher interest rates mean that sterling has built up quite a premium versus the dollar since 2003. However, this advantage is now being eroded with the UK economy slowing and the US expected to remain strong.

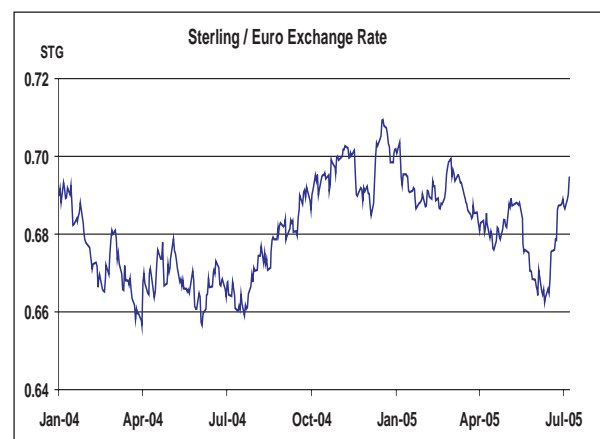
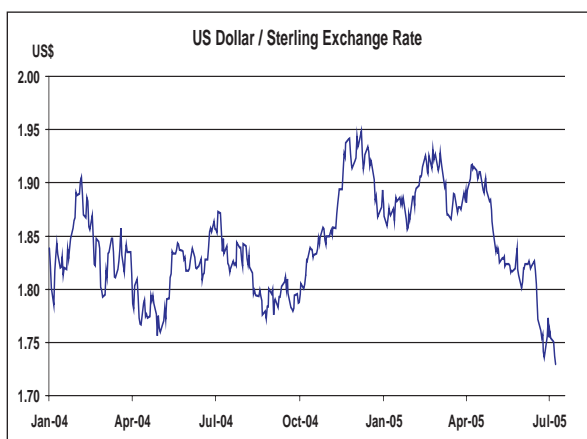
The US/UK interest rate differential currently stands at 1.50% but markets are predicting that this gap will have all but disappeared by year end. A UK rate cut is expected at the August meeting, with further easing possible in September or October. Meanwhile, the Fed is expected to continue to increase US rates over the balance of the year.

Given the impact of interest rate prospects on forex levels right now, we expect sterling to remain vulnerable in the weeks ahead as markets anticipate UK interest rate cuts. A rate cut in August is virtually a done deal at this stage but if we continue to get weak UK data thereafter, suggesting that further easing is in the pipeline, sterling will react negatively. Dollar/sterling could test recent lows in the near-term and a sustained breach of \$1.73 could trigger aggressive selling. Meanwhile, the euro should find strong support at the Stg69p level and could test Stg70p, if UK data remain weak.

High Oil Prices Hit Yen

As well as the more positive dollar environment, the yen has been hit by the recent rise in oil prices. Japan is almost totally reliant on imports to meet its energy requirements and thus the rise in prices could have a significant impact on economic activity. Higher energy prices have also hit Japan's trade surplus, which fell 26.4% (y-on-y) in H1-2005. IMM data show that net short positions are now running at their highest level in over six years, suggesting that the yen is oversold in respect of the recent trend in economic data.

High oil prices and rising US interest rates are likely to weigh on the yen in the short term, keeping it in check against the dollar and euro. However, it should strengthen gradually over the coming year as the Japanese economy gathers momentum. The long-awaited adjustment in China's exchange rate regime should also provide some support for the yen and indeed other Asian currencies versus the dollar and euro.





KEY MARKET EVENTS

Week 1 <i>(25 - 29 July)</i>	July 26	GER	Ifo Survey (July)
	July 27	US	Fed Beige Book
	July 29	Eurozone	Business and Consumer Confidence (July)
		Eurozone	HICP Flash Estimate (July)
		US	Real GDP 1st Estimate (Q2)
Week 2 <i>(1 - 5 August)</i>	August 1	US/UK/EU	Manufacturing PMI/ISM Surveys (July)
	August 3	US/UK/EU	Services PMI/ISM Surveys (July)
	August 4	UK	BoE Monetary Policy Announcement
		Eurozone	ECB Monetary Policy Announcement
	August 5	UK	Industrial Production (June)
US		Non-Farm Payrolls (July)	
Week 3 <i>(8 - 12 August)</i>	August 9	US	FOMC Monetary Policy Announcement
	August 10	UK	Bank of England Quarterly Inflation Report (August)
	August 11	Eurozone	GDP (Q2 Provisional)
		US	Retail Sales (July)
	August 12	US	Trade Balance (June)
		US	Univ. of Michigan Consumer Sentiment (Aug Prov.)
Week 4 <i>(15 - 19 August)</i>	August 16	UK	Consumer Prices (July)
		US	Consumer Prices (July)
		US	Industrial Production (July)
	August 17	UK	Minutes of BoE Meeting (3/4 August)
		UK	Unemployment Rate (June)
		US	Producer Prices (July)
	August 18	UK	Retail Sales (July)
		Eurozone	Harmonised CPI (Final July)

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