AIB Global Treasury
Economic Research

EXCHANGE RATE MONTHLY

March/April 2005

AIB Global Treasury Economic Research

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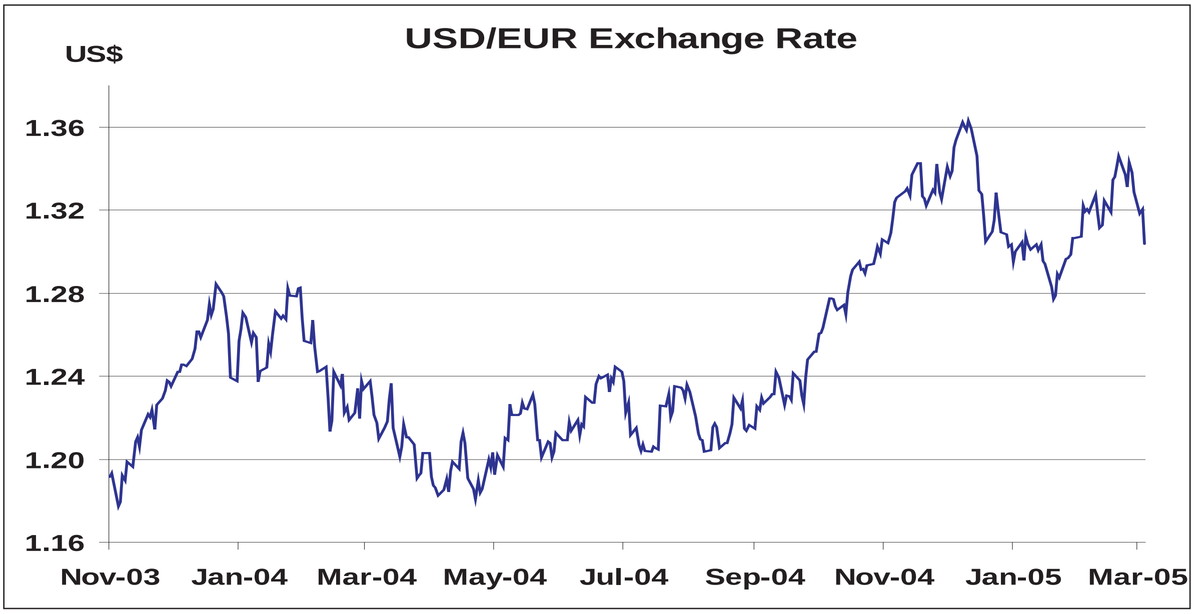
US Twin Deficits to Keep Dollar Under Pressure

- The risk of higher US inflation and thus more aggressive policy action from the Federal Reserve threatens a further dollar rally, which could force a test of $1.28 in USD/EUR. However, we believe that the euro should find support at this level.

- While the reaction to the Fed meeting of 22 March has provided a more positive back-drop for the dollar, the issue of US structural imbalances is central to our view that dollar sentiment will remain fragile over the course of 2005.

- The expectation of higher interest rates in the UK should provide underlying support for sterling versus the euro and dollar. However, a move away from fx carry trades and a modest dollar rally could see cable push towards $1.85.



Summary of Forecasts

Exchange Rates

Euro Versus		**Forecast Range Over The Period**			
	Current	**Q2 - 2005**	**Q3 - 2005**	**Q4 - 2005**	**Q1 - 2006**
USD	1.3038	1.30-1.35	1.32-1.37	1.32-1.37	1.30-1.35
GBP	0.6927	0.69-0.71	0.70-0.72	0.70-0.72	0.70-0.72
JPY	137.75	136-141	135-140	135-140	135-140
PLN	4.14	4.10	4.10	4.15	4.10

Dollar Versus		**Forecast Range Over The Period**			
	Current	**Q2 - 2005**	**Q3 - 2005**	**Q4 - 2005**	**Q1 - 2006**
JPY	105.65	102-107	100-105	100-105	102-107
GBP	1.8822	1.87-1.93	1.87-1.93	1.85-1.90	1.85-1.90
CHF	1.1925	1.17	1.15	1.17	1.18
AUD	0.7769	0.78	0.78	0.77	0.76

Official Interest Rates

		Forecast to End Period			
	Current	**Q2 - 2005**	**Q3 - 2005**	**Q4 - 2005**	**Q1 - 2006**
Euro Refi Rate	2.00	2.00	2.00	2.50	2.50
US Fed Funds	2.75	3.25	3.50	3.75	4.00
UK Base Rate	4.75	5.00	5.00	5.00	5.00
Japan ODR	0.10	0.10	0.10	0.10	0.10

Growth and Inflation

		GDP			**Inflation**	
Y-on-Y% Change	**2003**	**2004**	**2005**	**2003**	**2004**	**2005**
US	3.1	4.4	3.5	2.3	2.7	2.5
Eurozone	0.5	1.7	1.6	2.1	2.1	1.8
UK	2.2	3.1	2.7	1.4	1.3	1.7
Japan	1.4	2.6	0.8	-0.2	-0.2	-0.1
Ireland	3.7	5.5	5.5	3.5	2.2	2.1

Our View In Brief

* The world economy performed strongly in 2004 when real GDP rose by about 5%, the fastest growth rate in almost three decades. This was a very resilient performance considering the risks and uncertainties caused by factors such as global structural imbalances, geopolitical uncertainties and historically high oil prices. Global growth is expected to be in the region of 4% in 2005.

* **Oil prices have hit new record highs just below $60 per barrel (US crude oil) with an increase in production by OPEC failing to halt the upward trend. Thus, energy prices continue to impact on headline inflation. However, even if oil prices stay at their current high levels, the impact on annual inflation rates should diminish over the course of the year due to positive base effects.**

* The US economy has started 2005 on a favourable note with solid increases in manufacturing output, housing starts and core retail sales recorded in the first two months of the year. Consumer confidence levels remain high with other indicators also pointing to ongoing strength in activity in the months ahead. Employment growth is still relatively modest, but falling jobless claims point to stronger jobs growth in the months ahead.

* **The Fed is expected to continue its gradual pace of monetary policy tightening over the course of this year in response to a continuation of the upswing in economic activity and rising inflationary pressures. Indeed, the Fed is quite upbeat on the prospects for the US economy in 2005. We anticipate that the Fed funds rates will be at 3.75% by year end, which is a little below market expectations of a move to 4.00%.**

* **Despite a low core inflation rate and a weak economic environment, the ECB continues to warn of the risks to price stability posed by excessive liquidity. Interest rates in the eurozone have been at 2.0% for almost two years now, a situation that the ECB appears to be increasingly uncomfortable with. Thus, we continue to anticipate that official rates in the eurozone will be increased by up to 0.50% before the year end.**

* In the UK, we now expect that the Bank of England will increase interest rates by a further 0.25% before mid-year, with the repo rate likely to peak at 5.00%. There are distinct signs that the UK economy has regained momentum after the slowdown in activity in Q3-2004. House price data also suggest that conditions in the housing market have stabilised.

* Despite support from higher US interest rates, structural imbalances should continue to impact on dollar sentiment with talk of reverse diversification by global central banks also weighing. Thus, while in the short-term the euro could dip below the $1.30 level, there is scope for a move back to $1.32-1.37 territory. Over the course of 2005, the bulk of price action in dollar/euro could be confined to a $1.28-$1.35 range.

* Sterling remains volatile in familiar ranges with talk of a near-term hike in UK interest rates and a solid performance by the UK economy lending support. However, with a rate hike already priced in and evidence of waning interest in fx carry trades, upside potential could be limited. Indeed, a UK rate hike could well coincide with a peak in sterling.

23 March 2005

Interest Rate Environment

Fed To Continue Raising Rates

* The Fed has increased US interest rates by 0.25% at every FOMC meeting since June of last year. However, monetary policy remains accommodatory in the US.

* Thus, the Fed is expected to continue to gradually remove more of its monetary stimulus at forthcoming FOMC meetings. We anticipate that the Fed funds rate will 3.25% by mid-year and 3.75% at end 2005.

* There has been a marked rise in US longer term rates, with ten year yields hitting their highest level since last summer. The mood of the market suggests that yields are likely to remain under upward pressure in the months ahead.

US Interest Rates

	Current	Jun 05	Dec 05	Mar 06
Fed Funds	2.75	3.25	3.75	4.00
3 Month	3.03	3.50	3.90	4.20
1 Year	3.75	4.15	4.40	4.60
2 Year*	4.22	4.55	4.75	4.90
5 Year*	4.71	4.90	5.15	5.25
10 Year*	5.06	5.25	5.50	5.50

** Swap Forecasts Beyond 1 Year*

ECB On Hold Until Late 2005

* With growth in the eurozone still sluggish, wage rises subdued and the euro relatively strong, we see limited upside risks to inflation. However, the ECB continues to warn of the potential dangers of excessive liquidity. Comments suggest that it is increasingly uncomfortable with the fact that rates have been at 2.0% for a prolonged period.

* Our central forecast remains that official rates won't rise until late 2005. By end year, we expect that the official refinancing rate may have risen by 0.50% to 2.50%, though the risks to this forecast are to the downside.

* The rise in US long-term rates has put pressure on eurozone yields. However, the fact that the ECB is not expected to increase rates until the end of the year is providing some support. We see 10 year swap rates rising from 3.80% at present to 4.25% by end 2005.

Eurozone Interest Rates

	Current	Jun 05	Dec 05	Mar 06
Refi Rate	2.00	2.00	2.50	2.50
3 Month	2.11	2.15	2.70	2.70
1 Year	2.34	2.40	3.20	3.20
2 Year*	2.73	2.80	3.35	3.35
5 Year*	3.27	3.40	3.90	3.90
10 Year*	3.82	3.95	4.25	4.25

** Swap Forecasts Beyond 1 Year*

Bank of England To Hike Again

* The BoE voted to leave interest rates on hold at 4.75% in March. However, with the economy performing reasonably well and the housing market appearing to stabilise, rates are likely to be increased again over the coming months.

* The likelihood is that, with the general election expected to take place in May, the MPC will vote to increase the repo rate by 0.25% at the June meeting.

UK Interest Rates

	Current	Jun 05	Dec 05	Mar 06
Repo Rate	4.75	5.00	5.00	5.00
3 Month	4.89	5.10	5.10	5.10
1 Year	5.07	5.20	5.20	5.20
2 Year*	5.13	5.25	5.30	5.30
5 Year*	5.12	5.20	5.30	5.30
10 Year*	5.11	5.20	5.30	5.30

** Swap Forecasts Beyond 1 Year*

Exchange Rate Outlook

KEY ISSUES

- ***Dollar Takes On More Positive Tone:*** A failure to hold $1.35, conflict amongst EU policymarkers and a focus on US interest rates have all put the euro on the back foot against the dollar.
- ***Dollar Rally Could Be Short Lived:*** However, US structural imbalances still represent a serious obstacle to any dollar rally. We see scope for a move back to a $1.32-$1.37 range by mid-year.
- ***Sterling Looks to BoE For Support:*** Sterling is being underpinned by the prospect of further tightening in UK monetary policy but support should wane as rates peak.

Talk Of More Aggressive Action From Fed Supports Dollar

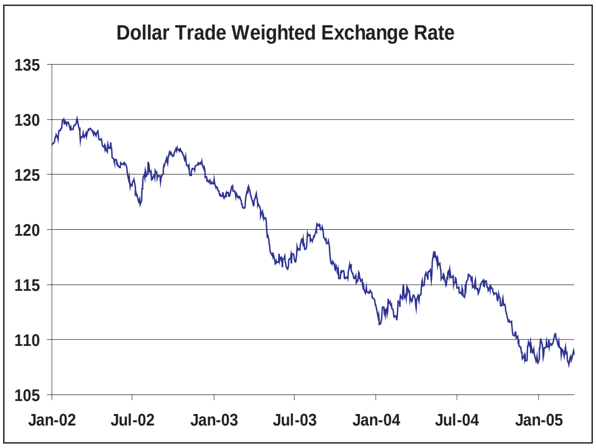
Cyclical themes, namely growth and interest rate differentials, are once again dominating forex markets. As anticipated, the Federal Reserve raised US interest rates by a further 0.25% on 22 March, bringing the Fed funds rate to 2.75%. While its remarks suggested that policy accommodation will continue to be removed at a measured pace, the overall tone of the FOMC statement (it noted that near-term inflation risks have risen) was more hawkish than previous ones.

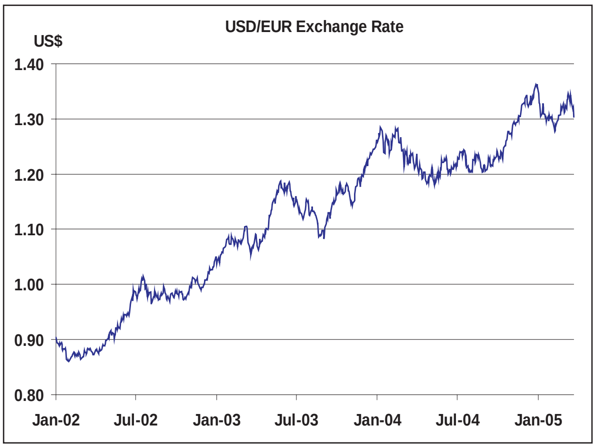
Talk of more aggressive action on US interest rates is lending support to the dollar against other majors, helping to push the euro to the $1.30 level. At this point, the futures market expects that officials interest rates in the US will be at 4.0% by year end, while rates in the eurozone may have risen by no more than 0.50% to 2.5%.

In addition to dollar favourable US interest rate trends, euro sentiment has also been damaged by the recent modifications to the EU's Stability and Growth Pact and the row over the deregulation of the services sector.

The current mood may result in a further dollar rally that could force a test of $1.28 in USD/EUR over coming weeks. However, the euro should find support at this level, as in the absence of any notable upside surprises on either the US growth or interest rate front, the scope for more significant dollar breaks to the upside seem limited.

We believe that for dollar sellers, any moves in USD/EUR to below the $1.30 level suggest selling opportunities. Continued increases in US interest rates are unlikely to be sufficient to reverse the dollar decline that has been evident for the last three years. Indeed, the benefit of interest rate differentials could well fade over time with policy changes already priced in.





The problem of the US twin deficit remains central to our view that dollar sentiment will remain fragile over the course of 2005 and we anticipate a move back to a $1.32-1.37 range by the euro over the longer term. The latest data show that the US current account deficit ballooned to $187.9bn in Q4 of 2004, a rise of some 13% on the previous quarter. For the year as a whole, the deficit increased to $617.1bn from $496.5bn in 2003, and now equates to cicra 5.5% of GDP.

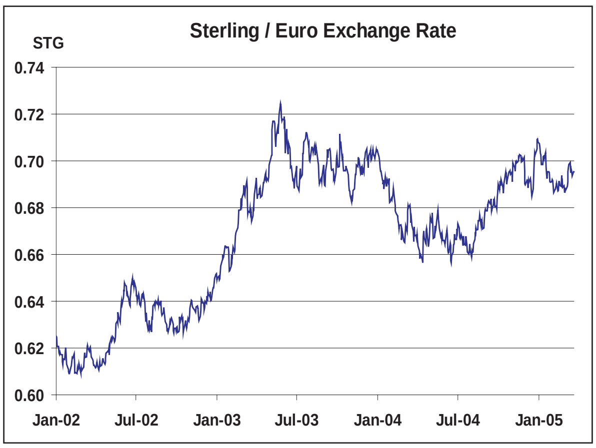
Capital flows data suggest that the US is still attracting a sufficient levels of funds to meet its current account deficit requirements. US net capital inflows reached $91.5bn in January, the second biggest inflow on record. The report clearly shows that foreigners still have a healthy appetite for US assets but also indicates that the dollar's recovery in January was supported by real money flows as well as technical factors.

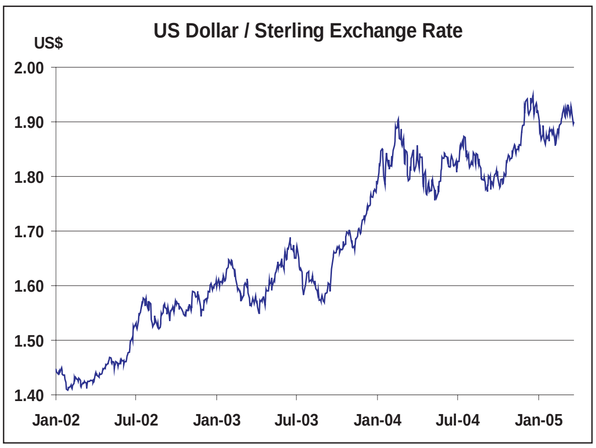
Total net capital inflows amounted to $824.1bn in 2004, compared to $683.6bn in 2003, which when compared to the size of the total deficit in 2004 also provides a degree of comfort. Over 40% of total net inflows were into US Treasuries. However, there are growing concerns about the foreign appetite for Treasuries. Indeed, February's capital flows data, which are due for release on 15 April, may not be dollar supportive, with Treasuries coming under pressure over the course of that month.

Another factor which should weigh on the dollar over the longer term is the issue of foreign exchange reserve diversification by global central banks. Recent studies suggest that China reduced the dollar share of its assets by 6% in 2004, at the same time increasing its exposure to the euro.

Meanwhile, the Central Bank of South Korea announced that it plans to seek higher returns on its foreign exchange reserves portfolio, suggesting a shift away from buying mainly dollars. South Korea currently holds $200.2bn in reserves, which are the fourth largest in the world, exceeded in magnitude only by Japan, China and Taiwan.

Shortly after the Korean announcement, the Japanese PM suggested to Parliament that "in general" Japan should consider diversifying its investments. The MoF quickly stated that it had no plans for now to shift the composition of its forex reserves. However, with markets already sensitive to the fate of the dollar, the comments provided yet another reason to sell the US currency. Reserve diversification could yet prove to be a major factor that weighs on the dollar throughout 2005.





Sterling Supported By Talk Of Higher Rates

While price action in dollar/euro is dictating overall direction of forex markets, sterling continues to be heavily influenced by domestic events and the actions of the Bank of England. The market now believes that the MPC will raise interest rates before the middle of this year. This expectation of higher rates (sterling is already the highest yielding major currency) should provide underlying support for sterling versus the dollar and euro.

However, a UK rate hike, most likely at the June MPC meeting, has already been well priced in by the market. In addition, the expectation of more aggressive policy action by the Fed has seen fx carry trades lose some of their appeal. Thus, sterling's upside potential on the interest rate story could be limited. Indeed, over the coming weeks, where UK data and talk of higher rates provide a boost to cable, it may prove beneficial for dollar buyers to take advantage of such rallies.

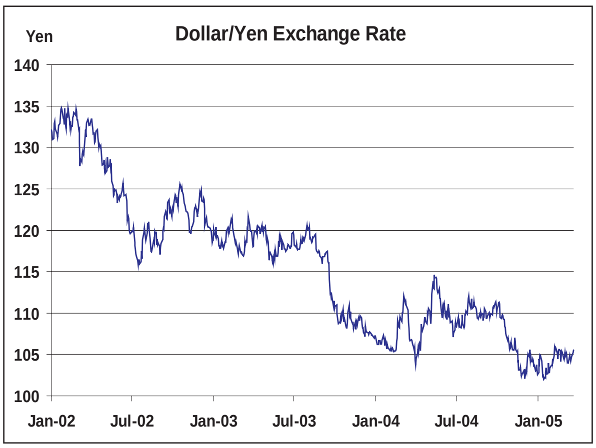
A rate hike could well coincide with a peak in cable, and we expect sterling to weaken back towards a $1.85 in the second half of the year as UK rates peak but those in the US continue to trend higher, thus eroding sterling's considerable yield advantage.

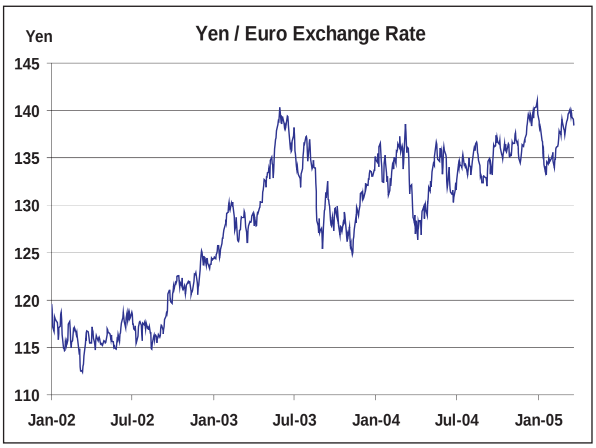
The euro has outperformed sterling versus the dollar of late, allowing the sterling/euro rate to move to the top end of the Stg0.68-0.70p range that has prevailed since the beginning of the year. We expect this range to remain in place for the foreseeable future, but there should be scope for the euro to move to beyond the Stg0.70p level once UK rates have peaked.

Yen Sticks To Tight Ranges

The yen continues to receive support from a number of sources including portfolio flows, Japan's large current account surplus and ongoing speculation of a revaluation in the Chinese yuan. At the same time, upside pressures have been limited by talk of higher US rates and the ongoing threat of BoJ intervention. Furthermore, Japanese data have failed to confirm any strong pick-up in economic activity. Thus, Y104 is proving to be a key resistance level for the yen.

We expect the dollar/yen rate to continue to trade in a tight range over the coming weeks, as markets focus on the prospects for US interest rates and await updates on the Japanese economy. Meanwhile, in terms of JPY/EUR, Y140 continues to represent a significant hurdle for the euro, particularly in the face of a modest dollar rally. The release of the Tanken Survey on March 31 will be a key event for the yen.





KEY MARKET EVENTS

Week 1 *(29 Mar - 1 April)*	**March 28**	**UK & Eurozone**	**Market Holiday**
	March 29	**US**	**Consumer Confidence (March)**
	March 31	**Eurozone**	**HICP Flash Estimate (March)**
		Eurozone	**Business and Consumer Confidence Index (March)**
		US	**Chicago PMI (March)**
		Japan	**Tankan Survey (March)**
	April 1	**Eurozone**	**Manufacturing PMI (February)**
		UK	**Manufacturing PMI/CIPS (February)**
		US	**Non Farm Payrolls Report (March)**
		US	**Manufacturing ISM/NAPM Survey (March)**
Week 2 *(3 Apr - 8 Apr)*	**April 4**	**Eurozone**	**Services PMI (February)**
	April 4	**UK**	**Halifax House Prices (March)**
		UK	**Services PMI/CIPS (February)**
	April 5	**US**	**ISM/NAPM Survey (Non-Manufacturing) (March)**
	April 7	**UK**	**BoE Meeting (2-day) & Rate Announcement**
		Eurozone	**ECB Meeting & Press Conference**
Week 3 *(11 Apr - 15 Apr)*	**April 12**	**US**	**Minutes of FOMC Policy Meeting (22 March)**
		US	**Trade Balance (February)**
	April 13	**US**	**Retail Sales (March)**
	April 15	**US**	**Net Capital Inflows (TICS Report - February)**
Week 4 *(17 Apr - 22 Apr)*	**April 17**	**UK**	**Minutes of BoE Policy Meeting (6/7 April)**
	April 19	**Germany**	**ZEW Expectations Balance (April)**
	April 20	**US**	**Beige Book**

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