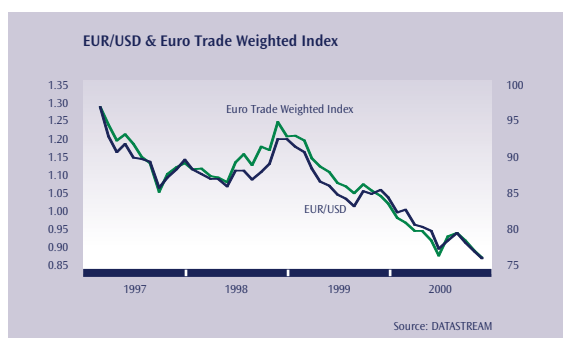


## Exchange Rate Prospects

### Intervention Puts Floor Under Euro

The surprise announcement of concerted intervention by the ECB, US Fed and the Bank of Japan on 22 September has put a floor under the euro at around \$0.85. Since the intervention, the euro has traded around \$0.86 – 0.88. The euro survived the negative outcome to the Danish referendum with the markets wary of central bank intervention. Where we go from here is still unclear. Unless there is a major setback in the US, which we do not anticipate, the most optimistic view is that the euro's short to medium term outlook is one of very gradual appreciation back towards parity with the dollar, but with setbacks along the way. However, it is unlikely at this stage that the euro will suffer a lasting downturn below \$0.80.

The “big picture” trading range for the next 6 to 9 months therefore, is \$0.80-\$1.00. Any serious breach of \$0.85 is expected to be met with intervention but unless the euro economy sustains its recent performance, repeated bouts of intervention will become less effective.



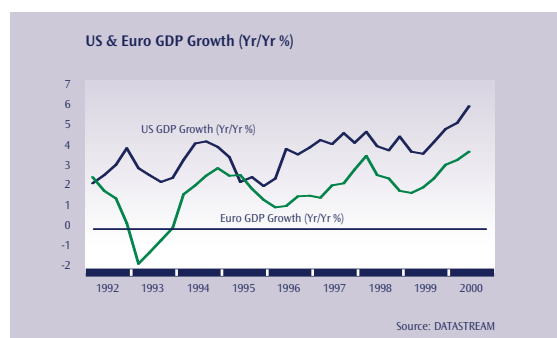
The arguments continue over whether the euro's fall against the US dollar and other major currencies is justified. European politicians and central bankers have argued that the fall in the value of the euro, both against the dollar and on a trade weighted basis, is not justified on the basis of economic fundamentals. They continue to express confidence, therefore, that the euro will recover.

### Is the Euro Undervalued?

When the major central banks intervened to support the euro, they did so on the basis that the fall in the single currency risked creating instability in the world economy. The Japanese authorities feared that an ever weakening euro would jeopardise Japan's fledgling economic recovery while the Fed also saw risks to US corporate earnings and to continued US economic

growth. Since the intervention in September, we have seen various reports from US corporates downgrading their earnings forecasts due to the high price of oil and the weakness of the euro. Notwithstanding the US Treasury's commitment to a strong dollar, a falling euro could have pushed the dollar to over extended levels at this late stage of the US economic expansion.

Based on the respective concerns of the Fed and the Bank of Japan, it is reasonable to conclude that the euro's dismal performance was a growing cause of concern on an increasingly global scale. From a European perspective, the weakness of the euro has a negative factor for UK manufacturing while within the euro area itself, eurozone exports were benefiting from the competitive currency.

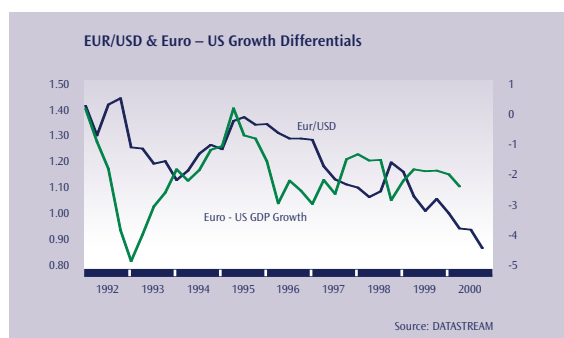


Through the period from early 1999 to recently, the ECB has explained the weakness of the euro as being due to the strength of the US economy. The spectacular growth in US GDP has significantly outperformed that of the eurozone. If US growth is much stronger than in the euro area, is the euro undervalued?.

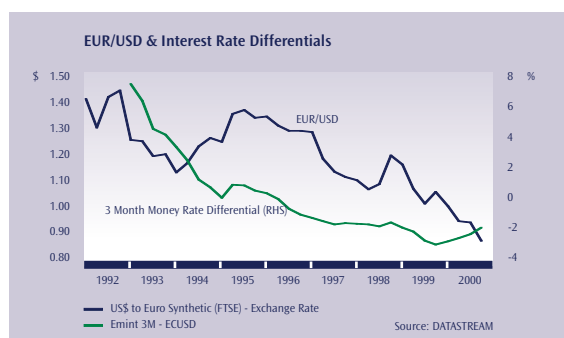
There is no doubt that judging the euro from its initial launch rate of \$1.175 to its low of below \$0.85 overstates the deadline of the single currency based on more longer-term fundamentals. The dollar suffered in the second half of 1998. Part of the euro's decline in early 1999 therefore reflected a bounce back in the USD.

Back in 1999, Ernst Welteke the President of the Bundesbank indicated at a rate of about \$1.08 represented a truer level for the EUR/USD rate. Based on current levels, the euro is over 18% below that “more appropriate” level. The ECB analysis of the current position of the EUR/USD rate is based on the argument that the currency relationship reflects the cyclical position of the US and euro economies.

## Exchange Rate Prospects



The chart shows that there is some basis to this view in terms of the broad trend between US-euro growth differentials and the movement of the currencies. A similar broad relationship is evident from the interest rate differential between the two economies. However, these rate differences merely reflect economic differences.



Both of these charts show that in recent times the economic/interest trend has moved in favour of the euro, through market sentiment has yet to reflect this. Based on IFO and PMI surveys, the prevailing view is that economic growth in the eurozone has peaked at about 3.5%. In the US, however, the latest data for Q2 '00 show a robust 5.6% annualised rate which is equivalent to 6.1% on a year-on-year basis. The markets are unsure as to the extent and duration of any possible US slowdown. However, forecasts for 2001 indicate that the rate of economic growth will be broadly similar in the US and euro economies. This forecast underpins the ECB's belief that the euro will recover in the short term. However, the markets are less convinced and will only push the euro higher when there is clearer evidence that the eurozone is

beginning to outperform the US economy on a fundamental long-term basis and not merely matching its short-term growth performance. The ECB also faces risks in terms of interest rate setting. The ECB's single mandate of price stability carries risks that the markets will take a negative view to higher interest rates. Some of the euro weakness is due to the large interest rate differential between the US and the eurozone but this is only a small part of the story. The ECB would like to narrow this gap. This can only occur over time. By end 2001 the current 3 months differential of 1.8% should be narrowed to 0.65%. The long-term rate gap should be closed by end 2001.

Nothing in the current outlook for the US or euro economies suggests that the EUR/USD is headed for a major reversal of fortunes. Based on the prospective trends in economic growth and interest rates, the euro is not set for rapid recovery. Financial markets are supposed to be forward looking. On this criterion, the euro should experience a modest cyclical revival. As we do not envisage a hard landing in the US, the dollar faces only a small risk of collapse based on the ever increasing deficit on the external account. Our forecasts are set out in the accompanying table.

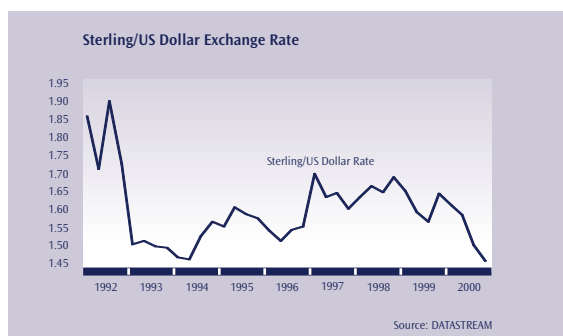
### Capital Flows Remain Negative for Euro

The eurozone recorded a deficit on current account of Eur 14 billion in the first seven months of 2000 compared with a surplus of Eur 21.4bn in the same period of 1999. The swing to deficit was primarily due to a lower goods surplus (Eur 35.5bn, down from Eur 60.9 bn) as well as higher deficits for service, income and current transfers.

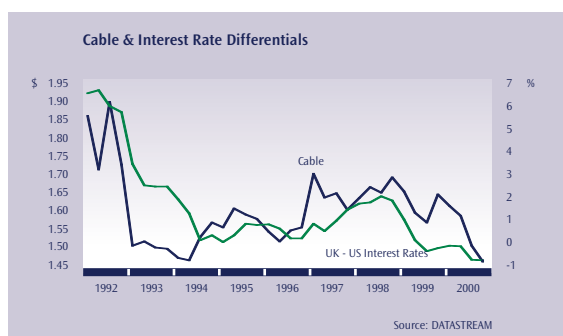
On the financial account, data up to July show that the net balance on direct investment and portfolio investment was negative to the tune of almost Eur 51bn. However this compared with a negative flow of almost Eur 143bn in the same period of 1999. In summary, the net outflows are slowing but the euro area is still being drained of capital, much of which is going to the US, where investors still believe that they will earn a higher return.

## Exchange Rate Prospects

### Sterling Feels Pressure of Strong US Dollar



Attention has naturally focused on the performance of the euro against the US dollar but sterling has also suffered increased volatility against the US dollar in recent months. Sterling's long-running stable relationship with the dollar stemmed from the relatively close correlation between the economic cycles in the US and the UK. This stretched back to the early 1990's when the two economies moved out of a period of recession/slow growth towards a much stronger performance. At the same time, economic growth in Continental Europe was adversely affected by German reunification. As a result, the economic cycles between the US and the UK on the one hand, and continental Europe on the other, moved out of synch. However, now with the UK experiencing a period of slower growth relative to the US, the markets are reassessing whether the US/UK economic cycles have decoupled. Of course, economic growth is also slowing in the US but the markets retain their faith in the sustainability of the US economic expansion. Doubts are emerging, however, about the UK. Data produced by the World Economic Forum (WEF) show that the US has become the world's most competitive country in 2000. Its position has improved from third most competitive economy in 1998. In contrast, the UK has fallen down the league table. The WEF shows that the UK is in ninth place, down from fourth in terms of global competitiveness in 1998. The UK still benefits from the fact that none of the major three eurozone economies feature in the top ten.



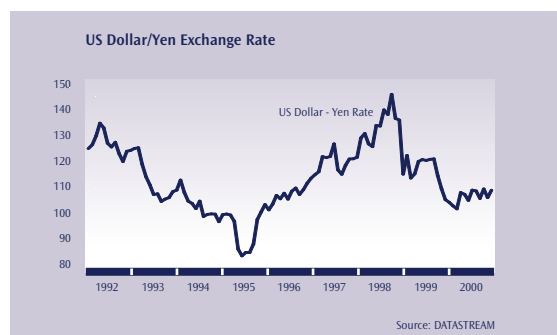
Interest rate differentials have also played a lead role in determining the relationship between sterling and the US dollar. As US rates rose in the course of 2000 and exceeded those in the UK, sterling weakened to below \$1.50. However, official interest rates appear to be on hold in both the US and the UK. This does not seem to have been a major factor in the weakening of sterling to below \$1.40 at one point.

Another factor in the weakness of sterling versus the dollar was related to the view that the UK currency was increasingly seen as aligning with the euro. At the present time, the chances of the UK joining the euro are remote. It is too early to conclude that sterling's relatively stable relationship with the dollar is over. Sterling is likely to trade within a new trading range of \$1.45-\$1.55 rather than the \$1.57-\$1.67 of the past three years.

### Yen to hold within Narrow Range Versus US Dollar

The USD/JPY rate has been relatively steady since the yen has benefited from the indications that the economy is recovering. It also moved higher prior to the announcement that the zero interest rate policy had ended. Since then, however, the dollar has moved higher but not to the same extent as its gain against European currencies. Latest Tankan survey data support the view that a modest recovery is underway in Japan.

Our forecasts point to a gradual strengthening of the yen over the next 6-12 months as Japanese economic growth becomes most established and as the US economy slows from its exceptionally strong expansion of the past three years. Undoubtedly, however, the Bank of Japan will occasionally employ verbal intervention to keep the dollar/yen rate within acceptable limits.



## Exchange Rate Prospects

Exchange Rate Forecasts *						
	Current	Q4 '00	Q1 '01	Q2 '01	Q3 '01	Q4 '01
<b>Euro versus</b>						
USD	0.8725	0.87	0.90	0.93	0.95	0.98
GBP	0.5980	0.59	0.61	0.62	0.63	0.645
YEN	94.25	93.1	96.30	97.7	98	98
CHF	1.5115	1.51	1.55	1.56	1.58	1.60
DKK	7.4652	7.45	7.45	7.45	7.45	7.45
NOK	8.063	8.00	8.10	8.20	8.30	8.40
SEK	8.615	8.50	8.40	8.45	8.50	8.60
<b>USD versus</b>						
GBP	1.4590	1.47	1.48	1.50	1.52	1.52
YEN	108.01	107.0	107.0	105.0	103.0	100.0
CHF	1.7325	1.74	1.725	1.64	1.62	1.66
CAD	1.5000	1.51	1.52	1.50	1.50	1.52
AUD	0.5250	0.54	0.58	0.60	0.62	0.64
<b>IEP versus</b>						
USD	1.1080	1.105	1.14	1.18	1.205	1.245
GBP	0.7600	0.75	0.775	0.79	0.80	0.82
YEN	119.69	118.2	122.2	124.0	124.2	124.5
CHF	1.9195	1.917	1.97	1.98	2.00	2.03
DKK	9.59	9.46	9.46	9.46	9.46	9.46
NOK	10.244	10.15	10.28	10.41	10.54	10.66
SEK	10.942	10.79	10.66	10.73	10.80	10.91

\* Rates represent projected min-points of range  $\pm 2.5\%$  at end of period.