

# EXCHANGE RATE MONTHLY

February 2004

## G7 Clears Way For Renewed Dollar Decline

- Dollar weakness will remain the chief focus over the coming months, at least until the US labour market shows broad based improvement and the Fed moves to tighten monetary policy (see page 5).
- February's G7 meeting called for more flexibility in exchange rates in order to address global imbalances. It attempted once again to shift the emphasis towards Asian currencies but the pressure remains elsewhere.
- With the BoE increasing UK interest rates to 4.0% sterling should outperform the euro versus the dollar, putting pressure on the euro at Stg0.675p (see page 7).

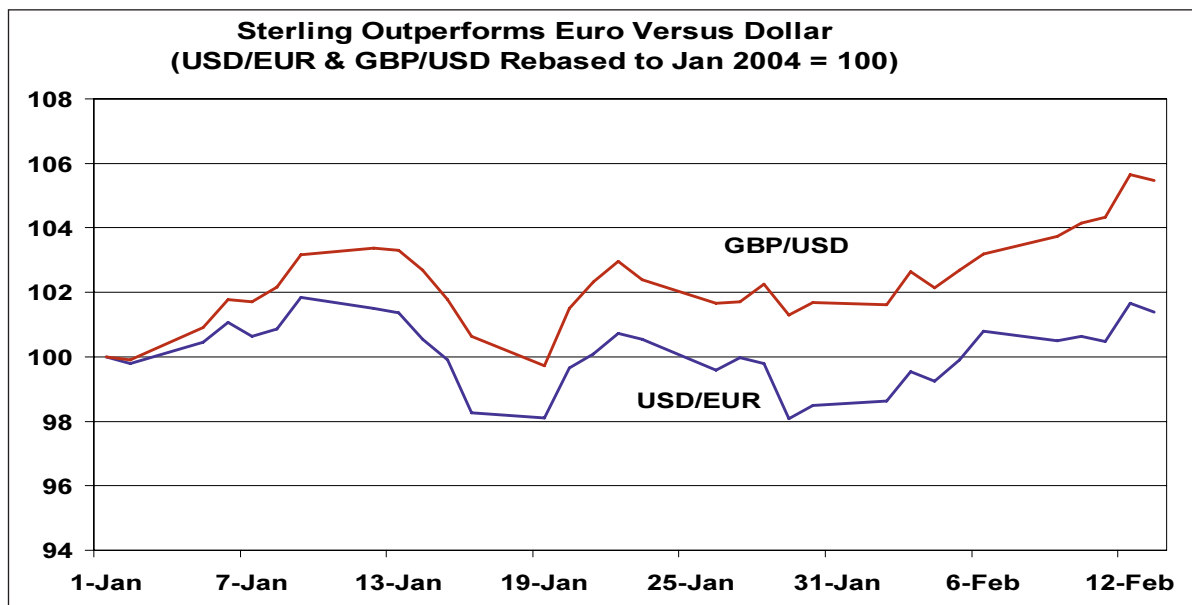
AIB Global  
Treasury  
Economic  
Research

John Beggs  
Chief  
Economist

Oliver  
Mangan  
Chief Bond  
Economist

Geraldine  
Concagh  
Senior  
Economist

Jenny  
Pollock  
Senior  
Economist



## Summary of Forecasts

### Latest View

- Main forex forecasts unchanged in light of the recent G7 meeting.
- Timing of first interest rate rise in the US will be crucial in setting the tone for dollar/euro.
- Sterling continues to attract buyers as UK rates move up, threatening the euro at Stg0.67p level.

### Exchange Rates

Euro Versus		Forecast Range Over The Period				
	Range Over the Last Month	Current	Feb-Mar 04	Apr-Jun 04	July-Sept 04	Oct-Dec 04
USD	1.23-1.28	1.276	1.22-1.32	1.20-1.28	1.22-1.28	1.25-1.30
GBP	0.675-0.70	0.675	0.66-0.69	0.66-0.69	0.67-0.69	0.69-0.71
JPY	131-137	134	130-137	128-135	128-135	130-137
CHF	1.56-1.57	1.57	1.57	1.55	1.56	1.57
NOK	8.53-8.86	8.78	8.85	8.80	8.75	8.60
SEK	9.10-9.21	9.15	9.10	9.00	9.00	8.90

Dollar Versus		Forecast Range Over The Period				
	Range Over the Last Month	Current	Feb-Mar 04	Apr-Jun 04	July-Sept 04	Oct-Dec 04
JPY	105-107	105	103-108	103-108	102-107	102-107
GBP	1.78-1.87	1.89	1.86-1.92	1.79-1.86	1.80-1.85	1.80-1.85
CHF	1.22-1.27	1.23	1.25	1.25	1.24	1.23
CAD	1.27-1.34	1.31	1.30	1.31	1.32	1.32
AUD	0.75-0.79	0.79	0.79	0.78	0.76	0.75

### Official Interest Rates

	Forecast to End Period				
	Current	Mar 04	Jun 04	Sept 04	Dec 04
Euro Refi Rate	2.00	2.00	2.00	2.00	2.25
US Fed Funds	1.00	1.00	1.00	1.75	2.25
UK Base Rate	4.00	4.00	4.25	4.50	4.75
Japan ODR	0.1	0.1	0.1	0.1	0.1

### Growth and Inflation

Y-on-Y% Change	GDP			Inflation		
	2003	2004	2005	2003	2004	2005
US	3.1	4.8	4.0	2.3	1.6	1.7
Eurozone	0.4	1.8	2.5	2.1	1.7	1.8
UK	2.1	3.0	2.8	1.4	1.6	1.9
Japan	2.2	2.2	2.0	-0.2	-0.2	-0.2
Ireland	2.0	4.0	5.0	3.5	1.9	3.0

## Our View In Brief

- \* **The recovery in the global economy continues to gather momentum.** Growth in the OECD area could reach in excess of 3.0% this year, the highest since 2000. The US economy is leading the way in this upswing, but the recovery in eurozone activity is modest to date. We do not anticipate that eurozone GDP growth will rise above trend until Q4 2004.
- \* **There are risks, however, that geopolitical tensions could be a feature of global markets again in 2004.** This factor, combined with low inventories and strong supply management from OPEC, means that oil prices could stay at \$30 per barrel or above over the course of 2004.
- \* **Official interest rates in the US and Europe are expected to rise this year.** However, weak US labour market data could delay the Fed until after mid-year. Given that the strength of the euro has already contributed to tighter monetary conditions in the eurozone, the ECB is unlikely to move before Q4-2004. Even then, policy tightening should be modest.
- \* Despite much speculation in the marketplace, we do not envisage an ECB interest rate cut in order to weaken the euro.
- \* The BoE added a further 0.25% to the repo rate in February. With the economy operating at above trend levels, further tightening is seen over the coming quarters. *For more details of our interest rate view, please see our latest **Fixed Income Monthly Monitor**, available online at [www.johnbeggs.com](http://www.johnbeggs.com).*
- \* **US labour market data are currently the key influence on Fed policy and thus on international bond markets.** US payrolls growth has been sluggish to date but we expect the US labour market to improve over the coming months. Thus, we believe that the Fed will tighten US interest rates considerably in the second half of the year. Furthermore, we look for US and European bond yields to rise in 2004.
- \* **Forex markets remain extremely volatile with the outlook for the dollar continuing to dominate.** Dollar sentiment remains negative but the upward pressure on the euro seems to have abated in the wake of comments by European officials. Thus, while \$1.30 may still be tested, upside momentum looks less pronounced than it did at the beginning of the year.
- \* Instead of focusing on the euro, markets are showing a preference for higher yielding currencies like sterling and the Australian dollar. **Sterling's outperformance versus the dollar has put sterling/euro under pressure below Stg0.68p.** This trend is likely to be maintained with further interest rate increases expected in the UK.

17th February 2004

## Interest Rate Environment

### ***Fed Stays Patient on Rates***

- \* At its January meeting, the Fed dropped its commitment to keep monetary policy accommodative for a considerable period of time. Instead, it indicated that it can be patient in removing its policy accommodation.
- \* An increase in US rates is not imminent. However, if as we expect, employment growth picks up in the months ahead, policy tightening is likely in the summer. The first rate rise, probably 0.25%, could occur in August.
- \* Markets are discounting some 0.50% of tightening in the US in 2004. We believe that the Fed will tighten by more than that and see official rates at 2.25% by year end.

US Interest Rates				
	Current	Mar 04	June 04	Dec 04
Fed Funds	1.00	1.00	1.00	2.25
3 Month	1.12	1.15	1.30	2.60
1 Year	1.29	1.30	1.80	3.10
2 Year*	2.01	2.20	2.50	3.30
5 Year*	3.40	3.70	3.90	4.60
10 Year*	4.41	4.60	4.80	5.30

\* Swap Forecasts Beyond 1 Year

### ***ECB Remains Comfortable On Rates***

- \* Recent commentary from the ECB indicates that it is comfortable with the current stance of eurozone monetary policy, despite the appreciation in the euro.
- \* Thus, our view on the outlook for eurozone monetary policy remains unchanged. We do not anticipate any change in official rates until late 2004, when we expect the refi rate to be raised by a modest 0.25%. This is broadly in line with market expectations.
- \* Longer term rates in Europe will take their cue from the US. As we expect US yields to move higher over the year, eurozone yields should follow suit. US 10 year rates, however, should be above those in Europe by the year end.

Eurozone Interest Rates				
	Current	Mar 04	June 04	Dec 04
Refi Rate	2.00	2.00	2.00	2.25
3 Month	2.06	2.10	2.10	2.40
1 Year	2.15	2.25	2.50	3.00
2 Year*	2.58	2.85	3.05	3.55
5 Year*	3.50	3.85	4.05	4.50
10 Year*	4.28	4.50	4.70	5.20

\* Swap Forecasts Beyond 1 Year

### ***BoE Delivers Another 0.25% Hike***

- \* At February's policy meeting, the BoE increased UK interest rates by 0.25% to 4.00%. The move was well anticipated by financial markets.
- \* With the UK economy operating above trend and the BoE expecting the CPI rate to trend upwards over its two year forecast period, further tightening is predicted over the coming quarters.
- \* We expect the repo rate to be at 4.75% by year end with a 0.25% hike in Q2 likely to be followed by a further 0.50% of tightening in H2. The market expects rates to be at 4.50% by year end.

UK Interest Rates				
	Current	Mar 04	June 04	Dec 04
Repo Rate	4.00	4.00	4.25	4.75
3 Month	4.15	4.25	4.55	5.00
1 Year	4.38	4.55	4.90	5.20
2 Year*	4.64	4.90	5.10	5.40
5 Year*	4.90	5.10	5.30	5.60
10 Year*	5.02	5.25	5.35	5.65

\* Swap Forecasts Beyond 1 Year

## Exchange Rate Outlook

### KEY ISSUES

- **G7 Fail To Turn Dollar:** Dollar weakness returns as G7 statement lacks any real substance, ultra low US interest rates also continue to weigh.
- **But Euro Upside Pressure Has Moderated:** Barrage of comments from Europe has left the market more cautious on the euro, but \$1.30 is still a target.
- **High Yields In Favour:** Sterling is benefiting from higher UK interest rates, outstripping the euro in its performance versus the dollar

### Dollar Stays Under Pressure Post G7

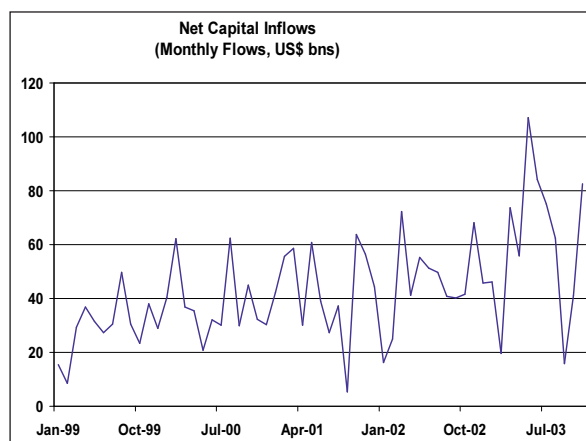
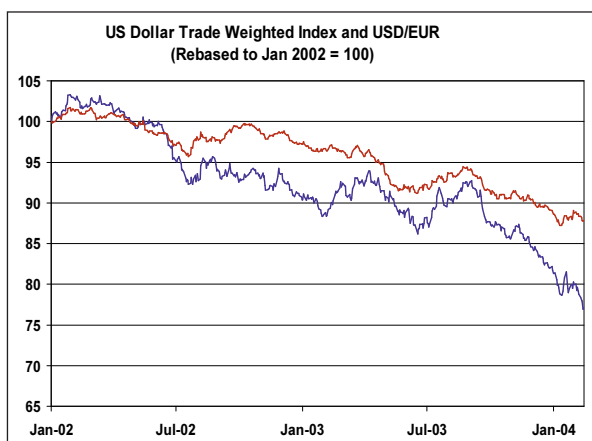
From mid September 2003 (the date of the last G7 meeting) to early January 2004 the dollar/euro appreciated from \$1.13-\$1.29, a move of some 13%. Direction was virtually all one way until the euro topped out just below \$1.29. A slew of defensive comments from eurozone officials left markets reluctant to extend the euro's upside towards \$1.30, thus providing scope for a corrective phase.

Since then, though, dollar/euro has remained volatile, activity has been predominantly confined to a six cent range. Bearing in mind the comments from Europe, markets adopted a cautious tone in the run up to February's G7 meeting, which took on heightened level of importance.

A subtle shift in the Fed's thinking on monetary policy at its January meeting, as well as better than expected US net capital inflows data for November, also provided support for the dollar. However, a flurry of market noise about the likely tone of the G7 meeting was the main driving force.

There was intense speculation that the group would take specific steps to halt the dollar's decline against the euro. When it finally came, **the communiqué did call for greater flexibility in forex markets and attempted to shift the burden of dollar adjustment towards Asia. However, the statement lacked any real substance** and was little more than an attempt at fine tuning September's remarks.

Thus, the status quo remains intact. **The dollar still needs to decline further in order to bring the US current account deficit back to a sustainable level.** However, as Asian central banks persist with intervention and quasi fixed exchange rate regimes, **the euro and Anglo-Saxon currencies will continue the bear the brunt of adjustment**, though not necessarily in equal proportions.



The euro has returned to recovery mode post the G7 meeting but some of the upward pressure seems to have abated. **It has been outstripped in its rebound versus the dollar by high yielding currencies like sterling and the Aussie dollar.** Official interest rates in these economies are at a respective 4.00% and 5.25%, offering a considerable premium not only against the US but also against the eurozone.

**Furthermore, dollar/euro has appreciated by almost 50% in the last two years.** Considering recent comments from European officials about the pace of the euro's rise, markets are still concerned that any further marked appreciation could be met with extended criticism or indeed direct intervention. **Against this backdrop, there appears to be a reluctance to test the \$1.30 level.**

Nevertheless, fundamental imbalances in the US, as well as ultra low interest rates, will continue to weigh on dollar sentiment over the coming weeks. **Recent remarks from Greenspan that a weaker currency could help reduce the current account deficit had a significant impact on the dollar.**

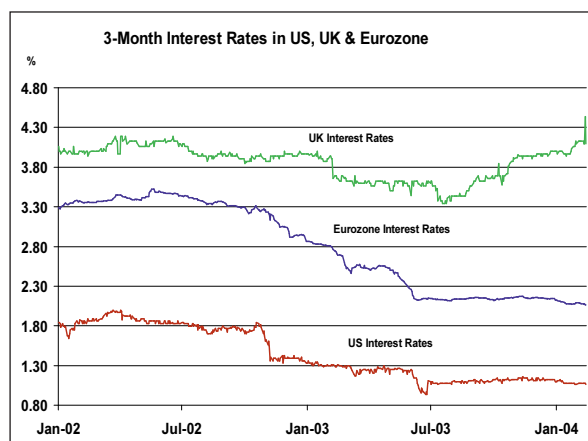
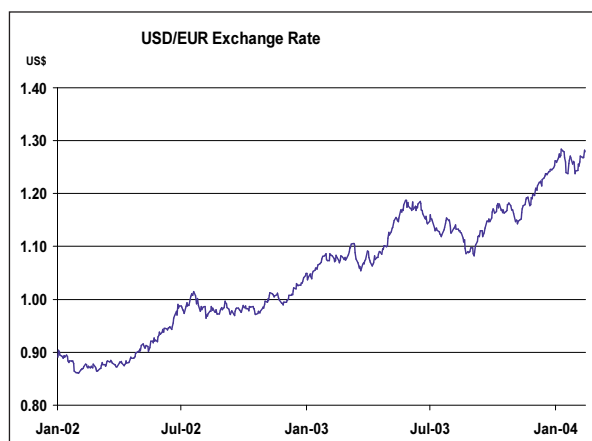
**Thus, we still see a risk of a move to a \$1.30-1.35 range, though this may represent the extent of the euro's upside capacity.** Furthermore, attempts at pushing the euro higher are likely to be more cautious now that the eurozone has shown its hand with regard to its comfort levels.

**Moving beyond the near-term, by mid-year markets should be anticipating an imminent move by the Fed to tighten US monetary policy. This should lend some support to the dollar, leaving scope for a euro correction back to \$1.20.** However, given the ongoing concerns about the twin deficits in the US, a dollar recovery may not be sustained over the second half of the year.

### ***Sterling Becomes Currency Of Choice***

**Sterling looks particularly attractive as a buy versus the dollar following the decision by the BoE to raise UK interest rates to 4.00% at its February meeting and the tone of its quarterly inflation report.** Expectations for further rate hikes over the coming months imply that, by the early summer months, the UK-US interest rate differential could be as wide as 3.25%.

**In addition, while markets have turned more cautious on euro/dollar, UK exporters have said very little about sterling's strength versus the US currency, since they are more likely to be concerned about its relationship with the euro. Also, intervention against the dollar would be an expensive option for the UK given the relative interest rate levels.**



Thus, after correcting all the way back to \$1.78 in mid-January, cable is now retesting 11 year highs at \$1.89 and is positioning itself for a move to a \$1.90-1.95 range. With the tightening cycle in the UK already well underway, \$2.0 could possibly even come under threat in the short-term.

As the US moves to tighten interest rates, sterling's rate advantage should wane, indicating a correction in cable back to \$1.80. For now, however, **its outperformance versus the euro will keep the sterling/euro rate under pressure below the Stg0.68p level.** As cable eases back in the second half of the year there should be scope for the euro to move back to a Stg0.69-0.71p range.

### ***BoJ Aggressively Defends Y105***

Japanese economic fundamentals continue to suggest that the yen should be appreciating across the board. However, **dollar/yen has traded in a very tight range of Y105-107 over the past month, with the BoJ intervening aggressively to prevent the dollar from slipping below the Y105.** This trend is not expected to change over the coming months, despite the G7 calls for greater flexibility on forex markets.

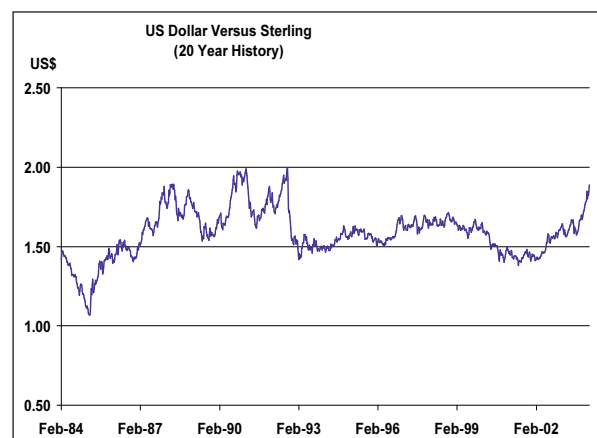
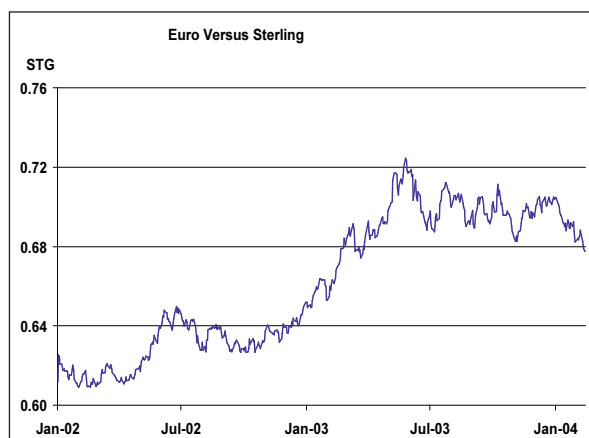
**Japan spent a record 7.15 trillion yen in forex intervention over the month of January,** prompting talk that the government would look to scale back the level of funds set aside for such purposes. Instead, **limits have been raised, providing the BoJ with an additional 21 trillion to spend between now and the end of the fiscal year (March).** The level of intervention funds for the next fiscal year has been set at 140 trillion yen, an increase of 40%.

The dollar should continue to trade with a downward bias and markets are likely to test the resolve of the Japanese authorities from time to time. However, with the BoJ armed with this level of spending power, **there seems little prospect of any real movement in dollar/yen beyond Y105.**

The euro's relationship with the yen, meanwhile, should continue to be primarily determined by its performance against the dollar. **We expect the yen/euro rate to trade in a 125-135 range over much of the year.**

### ***No Change Expected From China Despite Speculation***

**Futures market continue to price in a 5% revaluation in the Chinese yuan during 2004.** Renewed speculation about an imminent revaluation was fuelled by recent press reports. **However, the Chinese authorities have reiterated that the country has no plans to change its regime. Thus, a change in policy in 2004 still seems unlikely.**





# KEY MARKET EVENTS

<b>Week 1</b> <i>(23-27 Feb)</i>	<b>February 24</b>	<b>Eurozone</b>	<b>German Ifo Business Survey (Feb)</b> An important leading indicator on the eurozone economy, could have some impact on the euro.
	<b>February 25</b>	<b>US</b>	<b>Greenspan Testifies to House Budget Committee</b> This will be an important event for markets as they try and assess the mood of the Fed.
<b>Week 2</b> <i>(1-5 Mar)</i>	<b>March 1</b>	<b>US</b>	<b>ISM (NAPM) Manufacturing Survey (Feb)</b> A strong leading indicator, will be important for the dollar and US interest rate markets.
	<b>March 1</b>	<b>Eurozone</b>	<b>Manufacturing PMI (Feb)</b> A strong eurozone leading indicator in terms of the outlook for growth and interest rates.
	<b>March 3</b>	<b>US</b>	<b>Beige Book</b> Should provide some insight into the Fed's thinking on economic activity as the next FOMC meeting approaches.
	<b>March 3/4</b>	<b>UK</b>	<b>BoE Policy Meeting (2-day)</b> More rate hikes expected in 2004 but with BoE already well ahead in tightening cycle, next move may not be until May.
	<b>March 4</b>	<b>Eurozone</b>	<b>ECB Policy Meeting and Press Conference</b> No rate change expected but the post meeting press conference will be important. Watch in particular for comments on the euro.
	<b>March 5</b>	<b>US</b>	<b>Non-Farm Payrolls (Feb)</b> February's payrolls should be better than previous month. Another disappointing number could weigh heavily on the dollar.
<b>Week 3</b> <i>(5-12 Mar)</i>	<b>March 10</b>	<b>US</b>	<b>Trade Balance (Jan)</b> Given the focus on the current account deficit, movements in the trade balance will be important for the dollar.
<b>Week 4</b> <i>(15-19 Mar)</i>	<b>March 16</b>	<b>US</b>	<b>FOMC Meeting</b> No change in US rates expected, but watch for any change in the tone of the statement.
	<b>March 17</b>	<b>UK</b>	<b>Minutes of MPC Meeting (3/4 Mar)</b> The tone of the minutes and the voting pattern will be important for sterling.
	<b>March 17</b>	<b>UK</b>	<b>Budget (2004/2005)</b> Another key event for sterling, could also have implications on the taxation front.
	<b>March 18</b>	<b>US</b>	<b>FOMC Minutes Meeting (January 27/28)</b> Will be overshadowed by meeting earlier in the week but could still provide some key policy insights.

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