

EXCHANGE RATE MONTHLY

JANUARY/FEBRUARY 2005

AIB Global
Treasury
Economic
Research

John Beggs
Chief
Economist

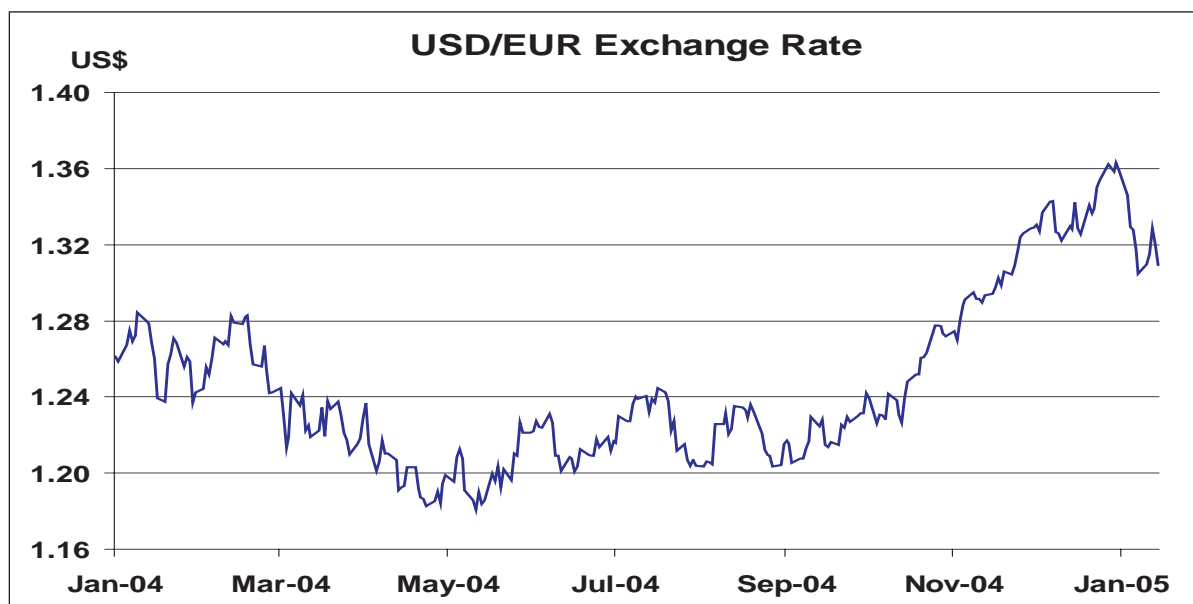
Oliver
Mangan
Chief Bond
Economist

Geraldine
Concagh
Senior
Economist

Jenny
Pollock
Senior
Economist

Euro To Reach New Highs Versus the Dollar in 2005

- We expect the dollar/euro rate to average \$1.36 in 2005. A prolonged period of dollar weakness is necessary to help correct US structural imbalances with the trade deficit continuing to expand at a record pace.
- UK consumer spending and housing data are heavily influencing the direction of sterling at present as markets debate the next move in UK interest rates.
- Dollar/ yen is trading around five year highs in the run up to February's G7 meeting. However, the BoJ has not intervened since March 2004, suggesting a change in its forex policy. Thus, a move to Y100 or below could be tolerated.



Summary of Forecasts

Exchange Rates

Euro Versus		Forecast Range Over The Period			
	Current	Q1 -2005	Q2 -2005	Q3 -2005	Q4 -2005
USD	1.3018	1.31-1.36	1.35-1.40	1.33-1.38	1.32-1.37
GBP	0.7013	0.70-72	0.69-0.71	0.69-0.71	0.68-0.70
JPY	133.57	134-139	134-139	132-137	132-137
PLN	4.08	4.10	4.20	4.25	4.20

Dollar Versus		Forecast Range Over The Period			
	Current	Q1 -2005	Q2 -2005	Q3 -2005	Q4 -2005
JPY	102.60	100-105	97-102	97-102	98-103
GBP	1.8600	1.86-1.91	1.94-1.99	1.91-1.96	1.92-1.97
CHF	1.1870	1.14	1.11	1.15	1.17
AUD	0.7520	0.77	0.78	0.76	0.75

Official Interest Rates

	Current	Forecast to End Period			
		Q1 -2005	Q2 -2005	Q3 -2005	Q4 -2005
Euro Refi Rate	2.00	2.00	2.00	2.00	2.50
US Fed Funds	2.25	2.75	3.00	3.25	3.50
UK Base Rate	4.75	4.75	4.75	5.00	5.00
Japan ODR	0.10	0.10	0.10	0.10	0.10

Growth and Inflation

Y-on-Y% Change	GDP			Inflation		
	2003	2004	2005	2003	2004	2005
US	3.0	4.4	3.5	2.3	2.6	2.6
Eurozone	0.4	1.8	1.9	2.1	2.2	1.8
UK	2.2	3.0	2.5	1.4	1.3	1.6
Japan	1.3	3.0	1.8	-0.2	-0.2	0.0
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.**
- * **Headline inflation rates increased in most economies in 2004, mainly due to higher oil prices. Oil prices should stay high in 2005. However, underlying inflation rates should remain fairly subdued. Global competition remains intense, which should continue to exert downward pressure on the goods components of national consumer price indices.**
- * **The recovery in the US economy remains intact. Recent commentary from the Fed shows an upbeat assessment of the economic prospects for the US, especially in regard to the outlook for consumer spending and investment. Continued gains in employment, the recent drop in oil prices and low interest rates should continue to boost spending on durable goods and housing.**
- * **The Fed raised US interest rates by 1.25% in 2004. It is expected to tighten policy by a similar amount in 2005 in response to a continuation of the upswing in economic activity. This would leave rates at 3.50% by year end.**
- * **With the upturn in the eurozone economy clearly losing momentum in H2-2004, we retain our view that the ECB will keep official rates at their current level of 2.0% until the final quarter of 2005. By end year we expect that the official refinancing rate could be at 2.50%. However, there are downside risks attached to this forecast. With growth sluggish and the euro appreciating, we believe that the upside risks to inflation in the eurozone are limited.**
- * **In the UK, we expect that the Bank of England will hold official rates at 4.75% for a considerable period of time. The direction and the timing of the next move in rates is in some doubt but we still see a possibility that the BoE may move to tighten monetary policy somewhat further in H2-2005 if the UK economy picks up momentum again given that there is very limited spare capacity.**
- * **The dollar has started 2005 on a relatively strong note, recovering sharply from the \$1.3667 low seen versus the euro in late December. The recovery has raised the question as to whether or not the dollar has troughed. We believe that it has not and expect the dollar/euro rate to average \$1.36 in 2005.**
- * **The G7 meets on 4-5 February. China's attendance has raised speculation of a change in its currency regime. This theme is likely to dominate forex markets over coming weeks and could keep currencies in relatively tight ranges as markets await the outcome. The possibility of a change in Asian forex policy presents upside risks for the yen versus the dollar and euro.**
- * **Sterling has been very volatile of late versus the euro, with UK economic data mixed and the market unsure as to the next move in rates. If over the coming months the euro does re-test the \$1.35 level, we could see the sterling/euro rate appreciate towards Stg0.72p but any evidence of a rebound in the UK will limit sterling's downside potential.**

18 January 2005

Interest Rate Environment

Fed To Hike Rates Further

- * The Fed increased US interest rates by 0.25% at all five FOMC meetings between June and December of last year. This brought the Fed Funds rate up from 1% to 2.25% by year end.
- * Monetary policy remains very 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 reach 3% by mid- 2005 and 3.5% by end year. This is broadly in line with market expectations.
- * Longer term rates are expected to rise over the coming year as the Fed reduces its monetary stimulus. Assuming steady economic growth and relatively modest inflation, the rise in 10 year rates should be not much more than 0.5% from current levels by end 2005.

ECB On Hold Until Late 2005

- * The upturn in the eurozone economy lost considerable momentum in H2 2004. With growth still quite sluggish and the euro appreciating, we believe that the upside risks to inflation are limited.
- * As a result, our central forecast is that official rates won't rise until late 2005. By end year, we expect that the official refinancing rate could have risen by, at most, 0.50% to 2.50%.
- * Looking to longer term rates, the eurozone is likely to follow the general direction of the US market, especially if the ECB starts to hike rates later in 2005. We see 10 year swap rates rising from 3.6% at present to above 4% by end 2005.

Bank of England On Hold

- * With the UK economy and the housing market slowing, inflation very low and considerable uncertainties about the economic outlook, the BoE is likely to leave rates on hold at 4.75% for sometime yet.
- * The direction of the next move in rates is unclear at present. The MPC could tighten policy by a further 0.25% in H2 2005 if growth rises back above trend, given that there is virtually no spare capacity in the economy.

US Interest Rates				
	Current	Mar 05	Jun 05	Dec 05
Fed Funds	2.25	2.75	3.00	3.50
3 Month	2.61	3.00	3.20	3.70
1 Year	3.17	3.50	3.70	4.00
2 Year*	3.60	3.85	4.00	4.25
5 Year*	4.10	4.30	4.50	4.70
10 Year*	4.60	4.80	5.00	5.20

* Swap Forecasts Beyond 1 Year

Eurozone Interest Rates				
	Current	Mar 05	Jun 05	Dec 05
Refi Rate	2.00	2.00	2.00	2.50
3 Month	2.11	2.13	2.15	2.70
1 Year	2.25	2.30	2.40	3.10
2 Year*	2.54	2.60	2.70	3.30
5 Year*	3.05	3.15	3.25	3.70
10 Year*	3.62	3.75	3.85	4.20

* Swap Forecasts Beyond 1 Year

UK Interest Rates				
	Current	Mar 05	Jun 05	Dec 05
Repo Rate	4.75	4.75	4.75	5.00
3 Month	4.76	4.80	4.90	5.10
1 Year	4.73	4.85	5.00	5.20
2 Year*	4.73	4.90	5.00	5.20
5 Year*	4.78	4.90	5.00	5.20
10 Year*	4.82	4.90	5.00	5.25

* Swap Forecasts Beyond 1 Year

Exchange Rate Outlook

KEY ISSUES

- **USD to Remain Under Pressure:** With the US trade deficit expanding at a record pace, the dollar is expected to come under further pressure in 2005, despite the fact that US interest rates will continue to rise. The euro could continue to bear the brunt of this adjustment.
- **Japanese Authorities to Tolerate Stronger Yen:** Despite the yen being at five year highs, the BoJ have not intervened since last March. This suggests that a move to Y100 or lower could be tolerated. There will be much focus on Asian currencies in the run up to February's G7 meeting.

Dollar to Face Further Downside Pressures in 2005

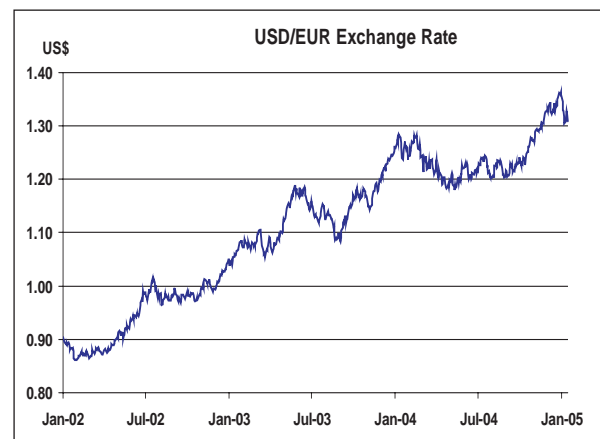
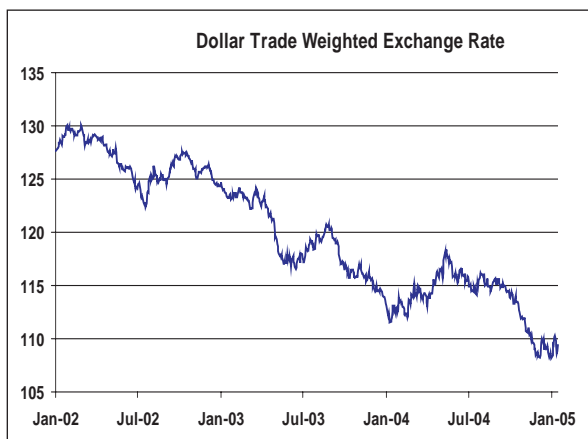
The dollar has started 2005 on a relatively strong note, recovering sharply from the \$1.3667 low seen versus the euro in late December. As a result, the euro is back trading in a \$1.30-1.32 range. The dollar has been boosted by a number of factors including expectations of higher US interest rates over 2005, a bullish set of minutes from the Fed's December meeting and supportive comments from the US administration.

Notwithstanding the importance of these fundamental factors, the dollar's recovery is also due to technical reasons, as markets respond to the excessive weakness seen in the run up to the holiday period. With the euro over bought on a short-term basis and the market short dollars, the USD was ripe for a short-term bounce.

Thus, the correction came as no great surprise and could even extend itself to \$1.28 and beyond over the coming weeks if US data and the view regarding the direction of US interest rates is supportive. The forthcoming G7 meeting could also provide some support for the dollar as markets speculate about a yuan revaluation.

Recent moves have raised the question as to whether or not the dollar has bottomed out. We believe that it has not. The market has not altered its fundamentally negative view of the dollar and the long-term weakening trend is likely to remain in place. At this point, we believe that the dollar's path of least resistance continues to be downward, with any rebounds likely to be temporary in nature.

There appears to be widespread acceptance that, given the structural problems being faced by the US economy, the dollar needs to be generally weaker for a prolonged period of time. Global central bankers are likely to facilitate such a scenario if the dollar's decline is an orderly one.



No Short-Term Solution to US Structural Problems

The US current account deficit, which has provided markets with a fundamental reason to go short the dollar, is not about to be reduced significantly anytime soon, as was clearly evident in November's trade data. A narrowing in the deficit requires greater national savings or a strengthening in domestic demand amongst the main trading partners of the US. Given the recent softening in a number of industrialised countries this seems unlikely.

The dollar also still faces downside pressures from political uncertainty. Furthermore, Asian central banks are unlikely to make significant changes to their exchange rate regimes, ensuring that the euro could continue to bear the brunt of the dollar's adjustment.

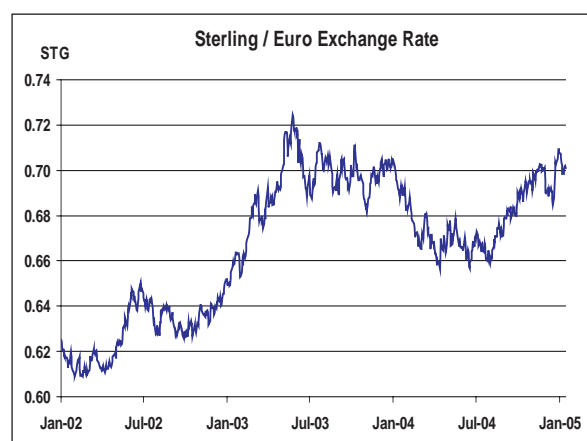
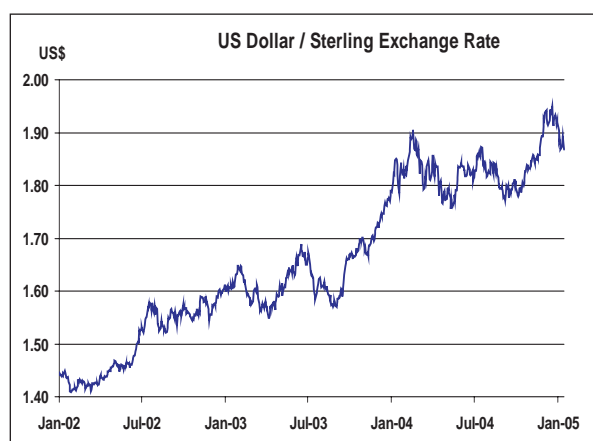
Against this background, our central view is that the dollar/euro exchange rate will average \$1.36 over 2005, which implies a weaker rate for much of the year than where the dollar is currently trading. In comparison, the average trading range in 2004 was \$1.24 and \$1.13 in 2003, so this forecast represents a considerably weaker dollar.

Over the course of the year the trading range could be as wide as \$1.25 -1.45. However, for the most part we would expect activity to be confined to a \$1.30-1.40 range. Given our central forecast, we would view any moves below \$1.28 as good value for dollar sellers.

There are a number of issues that will be crucial for the dollar over the course of 2005. These include the performance of the US economy and the outlook for US interest rates. The Fed has adopted a bullish stance on the economy and may yet be disappointed. With regard to the market's position on US interest rates, US inflation data could take on added significance in 2005, post the tone of the December Fed meeting.

The actions of the ECB (or indeed the lack of) will also be important, given that it still has the capacity to stop the euro in its tracks through either verbal communications or direct intervention. There have been few comments from eurozone officials over recent times but moves above \$1.40 could leave the ECB very uncomfortable. In our view an extension to \$1.50 would represent an overshoot by the euro.

The relative performance of the eurozone economy should also be closely watched. With a weak outturn generally expected again this year, any better than expected trends should be euro supportive.



Sterling Hit by Uncertain UK Economic Outlook

Sterling has been very volatile versus the euro in recent times, albeit within familiar trading ranges. While sterling has been influenced by the trend in the dollar/euro rate, the volatility has been mainly driven by the changing fortunes of UK economic releases, in particular housing and consumer spending data.

Sterling rallied in early December on the release of some strong sentiment surveys but slipped back towards the year end when, as we had anticipated, activity data disappointed. At this point, the market believes that UK rates have peaked and is even pricing in some chance that rates could be cut.

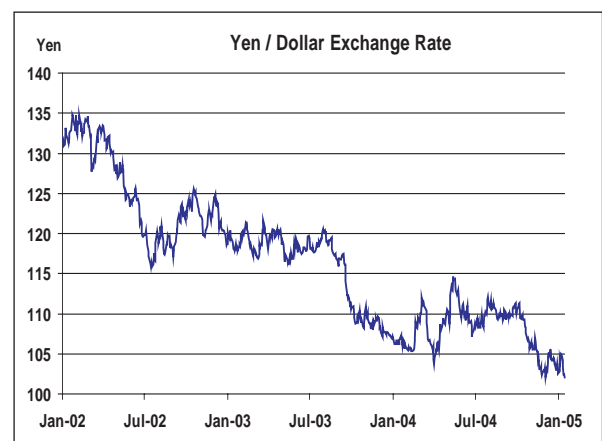
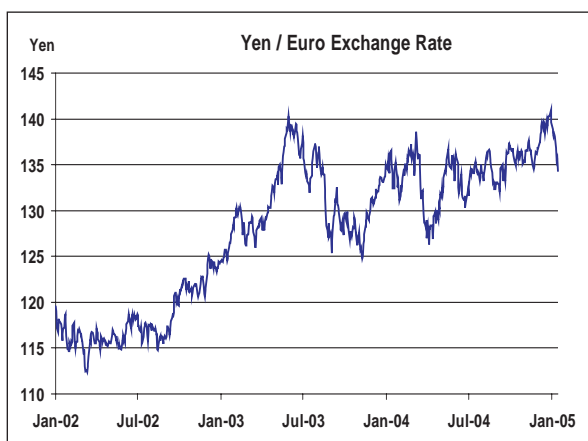
Given the mixed nature of UK data releases we believe that it is too early to call the end of the tightening cycle. Indeed, with little spare capacity in the UK economy, the BoE could raise interest rates again in 2005, by a modest 0.25%. This, and a return to trend growth, would underpin sterling.

Short-term, we expect sterling/euro to trade in a Stg0.70-0.72p range for the most part, but any strong UK numbers have the potential to push it towards the Stg0.69p level from time to time. Also, any potential correction in the dollar/euro rate towards the \$1.28 level could aid sterling versus the euro. Towards year end, we see potential for sterling to move towards Stg0.68p as higher UK rates provide support. Our average sterling/euro rate for 2005 is Stg0.71p, compared to Stg0.68p in 2004.

2005 Could See Dollar/Yen Break Y100

The dollar/yen rate averaged Y108 in 2004, compared with Y115 in 2003. Meanwhile, the euro/yen rate averaged Y134, virtually unchanged from Y131 in 2003. Heavy intervention by the BoJ has prevented the yen from appreciating significantly versus the dollar. Y14,831.4bn was spent in 2004, the second highest intervention level on record. However, all of the intervention activity was confined to the first quarter, despite the fact that dollar/yen has been trading around five year highs since early December.

This lack of action suggests that the BoJ may be willing to tolerate a move towards Y100 versus the dollar and possibly even beyond in 2005. However, much will depend on the performance of the Japanese economy and what steps, if any, are taken by the Chinese authorities towards revaluing its currency. In this regard, February's G7 could be crucial as a revaluation in the yuan would allow for greater flexibility for the dollar versus Asian currencies. We expect dollar/yen to average Y100 over the course of the year, with the euro/yen averaging Y135.



KEY MARKET EVENTS

Week 1 (17 Jan - 21 Jan)	January 18	UK	CPI (December) Discounting in the retail sector should have a positive impact.
		UK	RICS Housing Market Survey (December) Will be important for sterling.
		US	Capital Inflows (November) Will be viewed in the context of the trade data.
	January 19	UK	Unemployment (December) Labour market expected to remain tight.
		US	CPI (December) Inflation pressures should remain benign.
		US	Fed Beige Book Will set the tone for February's FOMC meeting.
	January 20	Eurozone	ECB Monthly Bulletin (December) Should reflect tone of press conference.
	January 21	UK	Retail Sales (December) December survey data have been very mixed.
	US	University of Michigan Consumer Sentiment (January) Provides the first insight into confidence levels in 2005.	
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Week 2 (23 Jan-28 Jan)	January 25	US	Consumer Confidence (January) Markets will be looking for an upbeat report.
	January 26	UK	Minutes of MPC Meeting (12/13 January) Will be important for sterling & interest rate markets.
		UK	GDP (First Estimate - Q4) Expect growth to be sub trend at 0.4%.
	January 28	US	GDP (First Estimate - Q4) Expect growth to be in the region of 3.5% (saar).
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Week 3 (31 Jan - 4 Feb)	January 31	Eurozone	HICP Flash Estimate (January) Inflation remains sticky above 2.0%.
	February 1	Euro/US/UK	Manufacturing PMIs (January) Markets will be looking for a further pick-up in activity.
		US	FOMC Meeting (2 Day) Expect rates to be increased by a further 0.25%.
	February 2	Eurozone	Services PMI (January) Some pick-up in activity is likely.
	February 3	UK/US	Services PMI (January) Indices should remain well above 50 level.
		Eurozone	ECB Meeting & Press Conference No change in rates expected.
	February 4	US	Non-Farm Payroll Employment (January) An important number for the dollar.
		UK	G7 Meeting (2-Day) Presence of China raises speculation of yuan revaluation.
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Week 4 (7 Feb - Feb 11)	February 10	Eurozone	ECB Monthly Bulletin (January) No change in rate outlook expected.
		UK	BoE Policy Meeting Ends No change in rates expected with UK data very mixed.

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