

## EXCHANGE RATE MONTHLY

February/March 2005

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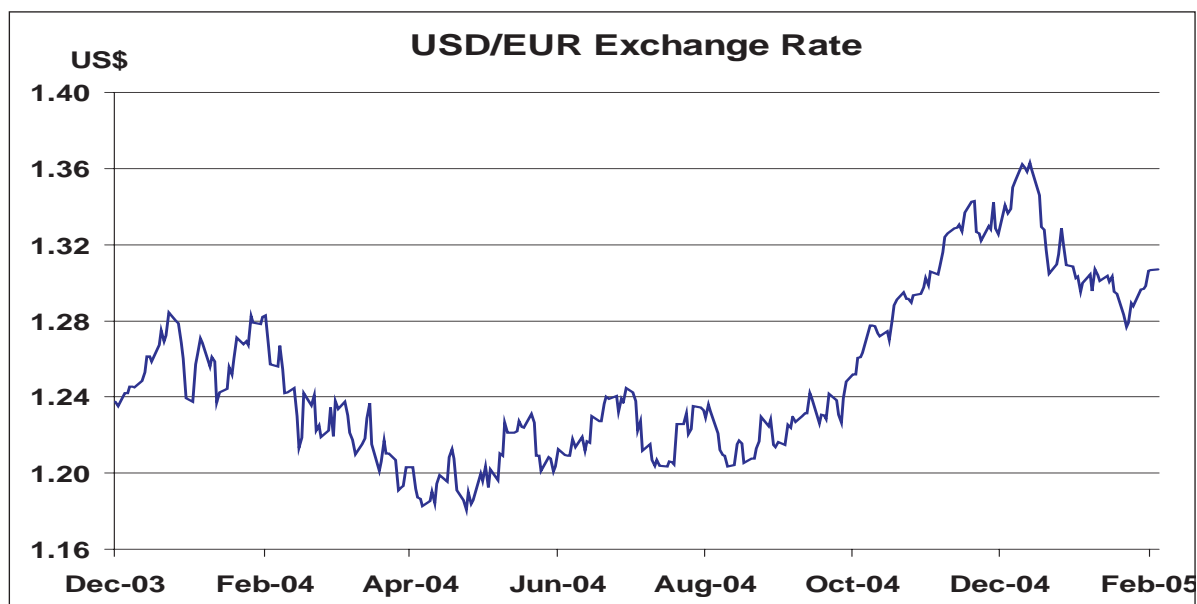
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### US Dollar Rebound Versus Euro Proves To Be Temporary

- Cyclical factors have turned dollar positive. However, fundamental imbalances in the US remain unresolved and the balance of risk remains weighted towards a weak dollar. We see dollar/euro in a \$1.32-1.37 range by mid year.
- Talk of UK rate cuts has proved premature. However, the outlook for monetary policy remains highly uncertain. Against this background, we expect sterling/euro to be volatile in a Stg0.68-0.70p range.
- The yen has also given way to a dollar correction. However, it continues to receive support from a number of sources. We expect dollar/yen to trade in a range of Y100-107 for much of H1-2005.



## Summary of Forecasts

### Exchange Rates

<b>Euro Versus</b>		<b>Forecast Range Over The Period</b>			
	<b>Current</b>	<b>Q1 -2005</b>	<b>Q2 -2005</b>	<b>Q3 -2005</b>	<b>Q4 -2005</b>
USD	1.3183	1.28-1.33	1.32-1.37	1.32-1.37	1.30-1.35
GBP	0.6907	0.68-0.70	0.69-0.71	0.69-0.71	0.68-0.70
JPY	137.30	134-139	133-138	135-140	135-140
PLN	3.98	4.05	4.10	4.15	4.10

<b>Dollar Versus</b>		<b>Forecast Range Over The Period</b>			
	<b>Current</b>	<b>Q1 -2005</b>	<b>Q2 -2005</b>	<b>Q3 -2005</b>	<b>Q4 -2005</b>
JPY	104.14	102-107	100-105	100-105	102-107
GBP	1.9086	1.88-1.93	1.92-1.97	1.92-1.97	1.90-1.95
CHF	1.1685	1.16	1.12	1.15	1.17
AUD	0.7935	0.79	0.79	0.77	0.76

### Official Interest Rates

	<b>Current</b>	<b>Forecast to End Period</b>			
		<b>Q1 -2005</b>	<b>Q2 -2005</b>	<b>Q3 -2005</b>	<b>Q4 -2005</b>
Euro Refi Rate	2.00	2.00	2.00	2.00	2.50
US Fed Funds	2.50	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

<b>Y-on-Y% Change</b>	<b>GDP</b>			<b>Inflation</b>		
	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>
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.**
- \* 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 prospects. There is an expectation that consumer spending may play a smaller role in the future. However, continued gains in employment, the easing back in oil prices and low interest rates should continue to boost spending on durable goods and housing. Meanwhile, business investment should remain strong.**
- \* **The Fed raised US interest rates by 0.25% on February 2. It is expected to continue its gradual pace of tightening monetary policy over the course of 2005 in response to a continuation of the upswing in economic activity. We anticipate that rates will be at 3.50% by year end, which is a little below market expectations.**
- \* **Although a number of eurozone leading indicators are pointing upwards, 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%. With growth sluggish and the euro expected to remain strong, 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. Although the MPC currently sees the balance of risks to growth and inflation to the downside 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.
- \* **After a strong start to the year, a number of factors continue to lend support to the dollar. However, it failed to hold gains below \$1.28 versus the euro and given the structural imbalances being faced by the US we continue to see the balance of risks to further dollar weakness. The euro, however, at this stage, may find it difficult to move through the \$1.40 level.**
- \* Sterling remains very volatile against other majors, with markets still unsure as to the next move in UK interest rates. Over the short-term, we expect sterling/euro to trade in a Stg0.68-0.70p range, with the euro benefiting from any weak UK data or dovish comments from the BoE. Over the balance of the year, however, we anticipate some pick-up in sterling, with the economic and interest rate environment in the UK turning more supportive.

*22 February 2005*

## Interest Rate Environment

### **Fed To Hike Rates Further**

- \* The Fed has increased US interest rates by 0.25% at every FOMC meeting since June of last year. This has brought the Fed Funds rate up from 1% to 2.5%.
- \* 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 reach 3% by mid-2005 and 3.5% by end year. This is a little below market expectations.
- \* Longer term rates are expected to rise as the Fed takes back more of its monetary stimulus. Assuming steady economic growth and relatively modest inflation, 10 year rates are forecast to rise by just over 0.5% by end 2005.

US Interest Rates				
	Current	Mar 05	Jun 05	Dec 05
Fed Funds	2.50	2.75	3.00	3.50
3 Month	2.80	3.00	3.20	3.70
1 Year	3.40	3.50	3.75	4.10
2 Year*	3.79	3.95	4.15	4.45
5 Year*	4.23	4.40	4.60	4.80
10 Year*	4.64	4.80	5.00	5.20

\* Swap Forecasts Beyond 1 Year

### **ECB On Hold Until Late 2005**

- \* The upturn in the eurozone economy lost considerable momentum in H2 2004. With growth quite sluggish, wage rises subdued and the euro relatively strong, 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 the official refinancing rate may have risen by 0.50% to 2.50% in response to the stronger growth in monetary aggregates.
- \* Looking to longer term rates, the eurozone is likely to follow an expected uptrend in US yields, especially if the ECB starts to hike rates later in 2005. We see 10 year swap rates rising from 3.75% at present to 4.25% by end 2005.

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	2.29	2.35	2.45	3.20
2 Year*	2.65	2.70	2.80	3.35
5 Year*	3.20	3.30	3.40	3.90
10 Year*	3.75	3.85	3.95	4.25

\* Swap Forecasts Beyond 1 Year

### **Bank of England On Hold For Now**

- \* With the housing market slowing, inflation very low and lingering uncertainties about the economic outlook, the BoE is likely to leave rates on hold at 4.75% for some time yet.
- \* The direction of the next move in rates is unclear. We feel that the MPC may 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.

UK Interest Rates				
	Current	Mar 05	Jun 05	Dec 05
Repo Rate	4.75	4.75	4.75	5.00
3 Month	4.80	4.85	4.90	5.10
1 Year	4.98	5.05	5.10	5.20
2 Year*	5.02	5.10	5.20	5.30
5 Year*	4.99	5.10	5.20	5.30
10 Year*	4.98	5.10	5.20	5.30

\* Swap Forecasts Beyond 1 Year

## Exchange Rate Outlook

### KEY ISSUES

- **Euro Remains Off Highs:** The euro remains well off its highs of late December as a number of short-term factors turn dollar supportive and markets focus on rising US interest rates.
- **Dollar to Resume Weaker Trend:** The dollar's improved performance has been underpinned by reduced fears over the c/a and fiscal deficits. However, fundamental imbalances remain unresolved.
- **Sterling Dependent on UK Rate Outlook :** Sterling remains volatile as markets debate the outlook for UK interest rates and the BoE highlights downside risks for the economy.

### Cyclical Factors Turn Dollar Supportive

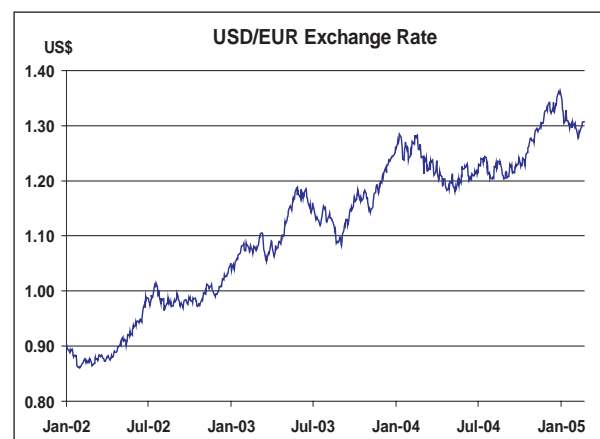
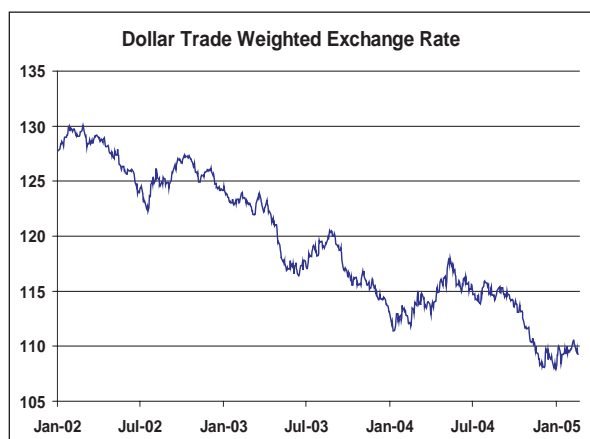
Sentiment towards the dollar has improved in recent times, suggesting that the rally in the euro is over, at least for the time being. Dollar/euro traded at \$1.2731 on 7 February, a gain of about ten cents on the dollar lows seen in late December. However, gains of this magnitude proved to be unsustainable with the euro back trading around the \$1.31 level.

A number of cyclical factors are nonetheless still offering a degree of support to the dollar. The US economy continues to grow at a solid rate and the labour market is improving. Against this background, the Fed is continuing with its measured pace of removing monetary stimulus from the economy, with the Fed Funds rate expected to be at 3.50% or somewhat above by year end.

The eurozone economy on the other hand is only showing the early signs of a pick-up in momentum from the downturn experienced in the second half of 2004. Thus, official interest rates there are likely to remain at their current 2.0% until well into the second half of the year. Even then, rate hikes should be modest, keeping the interest rate differential clearly in the dollar's favour.

We have also seen the liquidation of a sizeable number of short dollar positions over recent weeks. IMM data for the week ending 8 February show that, as a result of a swing into net short euro and yen positions, a net dollar long position was built for the first time since May 2004.

Also lending some support to the dollar is a speech delivered by Alan Greenspan on 4 February. Appearing less concerned about the current account deficit than on previous outings, he indicated that the market forces necessary for a rebalancing of global trade are finally coming into play. More cautious comments made back in November were one of the main factors behind the dollar sell-off in the run up to end 2004.



## ***But Correction Could Look to be Temporary***

The US appears to be making some inroads with regard to tackling its structural problems. There has been increasing evidence of a move to fiscal restraint, with President Bush announcing that he intends to reduce the Budget Deficit to 1.7% of GDP by fiscal year 2008, compared to a projected 3.5% for 2005.

The announcement of the details of Budget 2005 was met with some satisfaction by forex markets, who believe that the reduction in government spending will help reduce the current account deficit. At the same time, the latest TICs data show that US net capital inflows remain at a sufficient level to cover the trade deficit.

While its impact has now faded, heightened speculation of a revaluation in the Chinese yuan in the run up to the G7 meeting on 4/5 February also helped push the dollar higher against the euro.

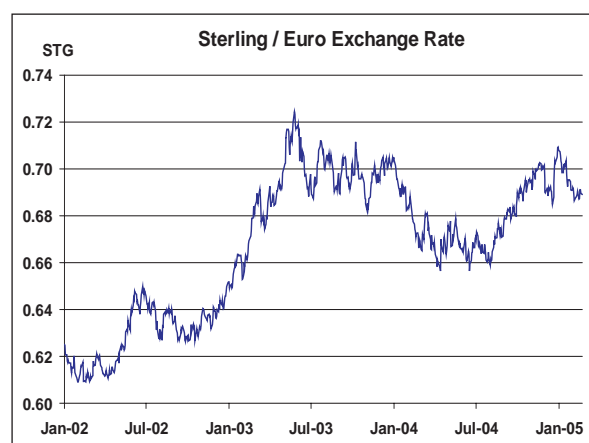
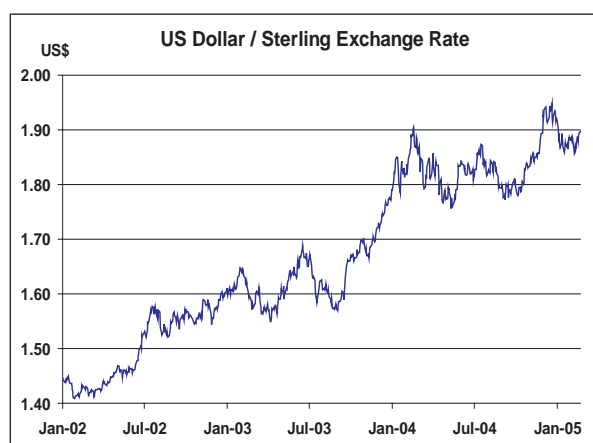
Allowing for the influence of these factors the impetus for the euro to move toward \$1.40 appears to be gone for now. At the same time, however, the dollar's potential to hold a \$1.25-1.30 range seems limited as a number of underlying fundamental factors should continue to weigh on the US currency.

While Greenspan sounded more optimistic on the current account deficit, reducing the US trade gap is still a mammoth task and will require a period of sustained dollar weakness for the mechanisms that Greenspan was talking about to have any lasting impact.

The US government's budget outlines cuts in spending aimed at shrinking the fiscal deficit over the medium term. However, the proposals do not include all spending on the war effort and homeland security. Thus, the plans are somewhat lacking in detail and realism and will not necessarily get through Congress or even then be met in full.

On the policy side, the G7 meeting turned out to be damp squib (yet again). Its statement was exactly the same as the one delivered a year previously. China, meanwhile, appears to be no closer to altering its currency peg with the US. Thus, for now, the euro could remain the key mechanism for dollar adjustment.

Finally, expectations of tighter US monetary policy supported a dollar correction in H1 2004. However, while US interest rates rose steadily from mid-year, the dollar took little comfort in widening interest rate differentials in the second half of 2004. Thus, while markets are once again citing this as a dollar supportive factor, its significance could fade as the year progresses.



Thus, while a firmer dollar (as compared with December's levels) may be a feature of forex markets over the coming weeks, we believe that current levels will prove to be unsustainable. The dollar has been on a downward trend for the past three years. However, this trend has been frequently interrupted by periods of recovery, many of which have been technically rather than fundamentally driven. We believe that we are currently in such a period and expect to see dollar/euro move to a \$1.32-1.37 range by mid year.

### ***Sterling Fortunes Tied to BoE***

Talk of interest rate cuts in the UK has proved to be premature with recent data being on the stronger side of expectations. However, the outlook for monetary policy remains highly uncertain with recent MPC commentary suggesting that rates will remain on hold for the time being.

Against this background, we expect sterling/euro to trade in a Stg0.68-0.70p range over the coming weeks, with sterling fluctuating within this range in line with the trend in UK data. Towards year end, we see potential for sterling to appreciate towards Stg0.68p, with increased UK rates driving it higher.

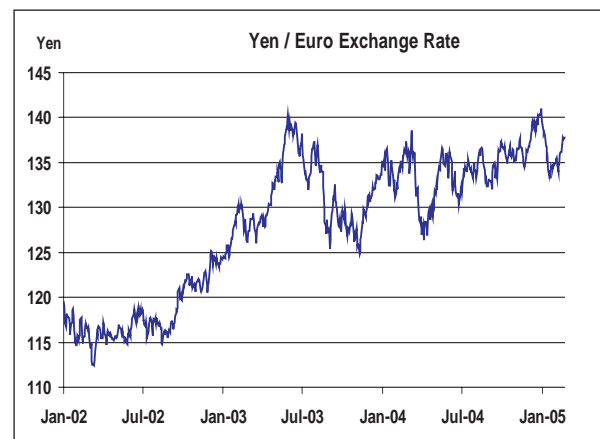
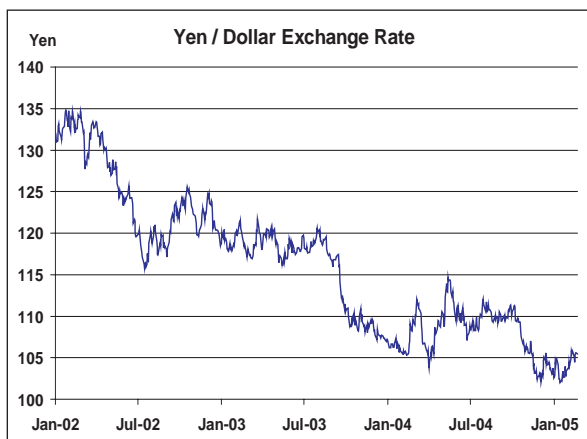
Sterling should remain strong against the dollar over the medium term, moving to a \$1.92-1.97 range by mid year as worries about the US deficit resurface and weigh on US dollar sentiment. Expectations of higher interest rates in the UK should also be a supportive factor. Beyond this, there is a risk that cable could dip towards \$1.90 as UK rates peak and rates in the US continue to move higher.

### ***Conflicting Forces to Keep Yen in Tight Range***

Like other majors, the yen has also given way to some improvement in the dollar. However, while dollar/yen has returned to levels not seen since last November, movements have been generally confined to a narrow range.

The yen continues to receive support from a number of sources including portfolio flows, a large current account surplus and ongoing speculation of a revaluation of the Chinese yuan, though the impact of this has waned post the G7 meeting.

At the same time upside pressures have been kept in check by the ongoing threat of BoJ intervention and disappointing Japanese activity data. We expect the dollar/yen rate to trade in a range of Y102-107 over the coming weeks. Repatriation of funds ahead of the Japanese fiscal year end in March may provide a short boost to the yen.





# KEY MARKET EVENTS

<b>Week 1</b> (20 Feb - 25 Feb)	<b>February 23</b>	<b>UK</b>	<b>Minutes of MPC (10 February)</b> Crucial for sterling given current volatility on rate talk.
		<b>US</b>	<b>FOMC Minutes (1/2 February)</b> Should be similar in tone to Greenspan's Testimony.
	<b>February 25</b>	<b>US/UK</b>	<b>GDP - 2nd Estimates (Q4)</b> Some upward revision expected in the US numbers.
<b>Week 2</b> (27 Feb - 4 Mar)	<b>February 28</b>	<b>Eurozone</b>	<b>Business &amp; Consumer Confidence (February)</b> Markets will be looking for signs of improvement in business and consumer confidence.
		<b>US</b>	<b>Chicago PMI (February)</b> Will set the tone for manufacturing ISM report.
	<b>March 1</b>	<b>US/Eurozone/UK</b>	<b>ISM/PMI Manufacturing (February)</b> US numbers will be important for dollar direction.
		<b>Eurozone</b>	<b>HICP Flash Estimate (February)</b> Inflation expected to trend lower.
	<b>March 3</b>	<b>US/Eurozone/UK</b>	<b>ISM/PMI Services (February)</b> US numbers likely to dominate.
		<b>Eurozone</b>	<b>ECB Meeting and Press Conference</b> No change in rates expected.
	<b>March 4</b>	<b>US</b>	<b>Non-Farm Payroll Employment (February)</b> Key indicator for the dollar's tone ahead of the next FOMC meeting.
<b>Week 3</b> (6 Mar - 11 Mar)	<b>March 9</b>	<b>UK</b>	<b>Industrial Production (January)</b> Will we see a repeat of December's strong report?
	<b>March 10</b>	<b>Eurozone</b>	<b>ECB Monthly Bulletin (February)</b> Should reflect the tone of the press conference.
	<b>March 11</b>	<b>US</b>	<b>Trade Balance (January)</b> Will the data continue to show an improvement?
<b>Week 4</b> (13 Mar - 18 Mar)	<b>March 14</b>	<b>UK</b>	<b>Producer Prices (February)</b> Sharp increase in January PPI numbers took markets by surprise.
	<b>March 15</b>	<b>GER</b>	<b>ZEW Survey (March)</b> Any further rise would underpin hopes for brighter outlook.
		<b>US</b>	<b>Retail Sales (February)</b> Consumer spending expected to remain solid.
		<b>US</b>	<b>Net Capital Inflows (January)</b> Will be viewed in context of January trade data.
	<b>March 16</b>	<b>UK</b>	<b>Unemployment (February)</b> UK labour market set to remain tight.
		<b>UK</b>	<b>MPC Policy Meeting Ends</b> No change in rates expected.
	<b>March 17</b>	<b>UK</b>	<b>Retail Sales (February)</b> The trend in consumer spending is being closely watched by the BoE.
		<b>US</b>	<b>Philadelphia Fed Survey (March)</b> Important leading indicator ahead of March ISM report.

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