

AIB Corporate & Commercial Treasury



# Monthly Market FOCUS



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## Overview

- Much of the economic evidence released since our last publication is supportive of the view that a modest recovery is underway in the global economy. However, a sustained rebound in the US is crucial to this global recovery.
- In this regard, data from the US are becoming increasingly encouraging. Much of the positive news from the US centres around December's better than expected ISM (formerly NAPM) reading. Consumer confidence has also rebounded from its fall after the September 11 attacks and there are indications that the labour market is stabilising.
- Despite signs of stabilisation, we believe that the US, and therefore the global economy, still faces considerable risks. With a rebound in the US economy by no means guaranteed, the Fed will stay in a friendly mode. We expect US rates to be reduced by a further 0.25% to 1.50% at its end January meeting. Rates should then remain on hold for some time, possibly until well into the second half of the year.
- With the rate of eurozone inflation falling over the course of the year, a benign interest rate environment should also prevail in the eurozone. Financial markets are not pricing in any further reduction in official rates but we feel that there is scope for the ECB to cut rates by another 0.50%, bringing the refi rate to 2.75%.
- In the UK, the Bank of England appears to have concluded its policy easing, with rates bottoming at 4.0%. The next move in UK interest rates is expected to be upwards but all indications from the BoE are that this will not come until there is firm evidence of a rebound in the global economy.
- Once again, a strong New Year performance proved to be a false dawn for the euro. As suspected, the launch of the euro notes and coins provided little more than a temporary boost. The biggest threat that the euro faces this year is a rebound in the US economy. If the US economic does grow strongly, the euro will be vulnerable to a fall back to \$0.85.
- The issue of EMU membership is becoming an increasingly dominant force in the sterling/euro trading relationship. It is widely accepted that sterling needs to depreciate before joining the single currency. However, membership is highly unlikely in the short to medium term. Under increasing pressure on its domestic agenda, the UK government may be forced to concentrate on domestic matters in the months ahead. The risk that the UK will eventually join means that there is little scope for a marked appreciation in the sterling/euro rate.
- The Irish economy is expected to grow by 3.5% in 2002. With the economy starting the year with no momentum, much of this growth is forecast to come in the second half of 2002.

## Summary of Forecasts

Exchange Rates							
Euro Versus			Forecast Period				
	Range Over the Last Month	Current	0-1 Month	1-3 Months	3-6 Months	6-9 Months	9-12 Months
USD	0.878-0.904	0.8845	0.87-0.90	0.88-0.92	0.88-0.92	0.87-0.91	0.85-0.90
GBP	0.607-0.625	0.6160	0.60-0.62	0.61-0.63	0.61-0.63	0.62-0.64	0.62-0.64
JPY	114.13-119.47	117.23	115-122	114-124	113-124	117-127	108-120
CHF	1.465-1.485	1.4696	1.47	1.48	1.50	1.50	1.49
DKK	7.430-7.441	7.4320	7.45	7.45	7.45	7.45	7.45
NOK	7.893-8.030	7.9185	8.00	8.00	7.95	7.90	7.80
SEK	9.162-9.526	9.2211	9.20	9.15	9.00	8.90	8.70

Dollar Versus			Forecast Period				
	Range Over the Last Month	Current	0-1 Month	1-3 Months	3-6 Months	6-9 Months	9-12 Months
JPY	127.5-132.77	132.55	130-135	130-135	135-140	135-140	135-140
GBP	1.436-1.457	1.4361	1.43-1.47	1.43-1.47	1.43-1.47	1.38-1.42	1.37-1.40
CHF	1.632-1.691	1.6615	1.66	1.64	1.66	1.68	1.70
CAD	1.575-1.614	1.6147	1.60	1.58	1.56	1.55	1.50
AUD	0.505-0.524	0.5174	0.51	0.53	0.52	0.51	0.50

Interest Rates						
Key World Interest Rates		Forecast Period				
	Current	0-1 Month	1-3 Months	3-6 Months	6-9 Months	9-12 Months
Euro Refi Rate	3.25	3.25	3.00	2.75	2.75	2.75
US Fed Funds	1.75	1.50	1.50	1.50	2.00	2.75
UK Base Rate	4.00	4.00	4.00	4.25	4.50	5.00
Japan ODR	0.10	0.10	0.10	0.10	0.10	0.10

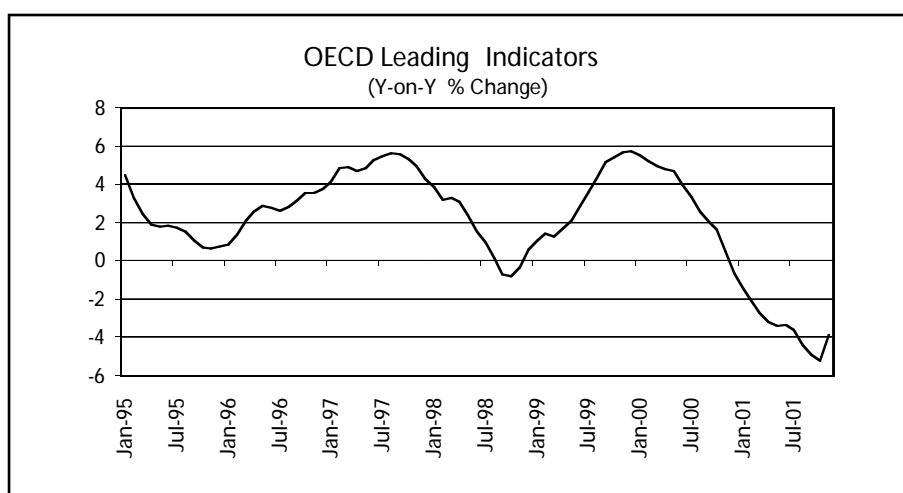
Growth & Inflation				
	Forecast Period			
	2001		2002	
<i>Y-on-Y % Change</i>	<i>GDP</i>	<i>CPI</i>	<i>GDP</i>	<i>CPI</i>
US	1.0	2.9	1.0	1.7
Eurozone	1.6	2.6	1.3	1.5
UK	2.5	2.1*	2.0	1.9*
Ireland	7.7	4.9	3.5	3.7

\* Inflation rate excluding mortgages

## Global Agenda

### Global growth of 2% in 2002

Global economic growth slowed to about 2% in 2001, less than half the rate of growth recorded in 2000. Much of this slowdown was due to the sharp fall-off in the rate of economic growth in the US and the eurozone. The average rate of growth in these two key zones in 2002 will be broadly similar to their respective growth rates in 2001. As a result, the growth in world GDP in 2002 is expected to stay around 2%. However, by 2003, the annual rate of global GDP growth should improve to over 3.5%. Leading indicators suggest that we are approaching the bottom of the current international downturn, particularly in respect of the sharp decline in the manufacturing sector.



### Inflation to ease in 2002

With the overall weakness of global economic growth, inflation is not expected to be a major problem in 2002. There is now a negative output gap in the major economies, which should allow economies to grow above trend without risking an acceleration in inflation in the short term. Indeed, inflation rates are generally expected to ease in the US and eurozone economies as the corporate sector exerts downward pressure on wage and non-wage costs in order to improve profitability. Competitive pressures will continue to constrain companies' pricing power.

### Risks to US recovery

There is general optimism that 2002 will represent a turning point for the world economy. However, significant risks and uncertainties remain about the outlook. US economic recovery could falter leaving the Fed in a quandary about interest rate policy. We expect the Fed to cut the Fed funds rate to 1.5% and that this will represent the bottom of the cycle. The effectiveness of further cuts must be questioned. We look for some gradual tightening in the second half of the year. We remain bullish on the US dollar though the corporate sector has adopted a more positive attitude towards the euro. A significant fall in the dollar would damage European growth prospects.

### Major issues for Europe in 2002

The US economy appears to have recovered well from last September's terrorist attacks. Of course, some lasting problems remain in the aviation and tourism sectors. Most forecasts for the international economy in 2002 are treating the events of last September as a one-off event. In Europe, major issues this year will be economic and institutional reform, EU enlargement and the possibility of Sweden, Denmark and the UK joining the euro.

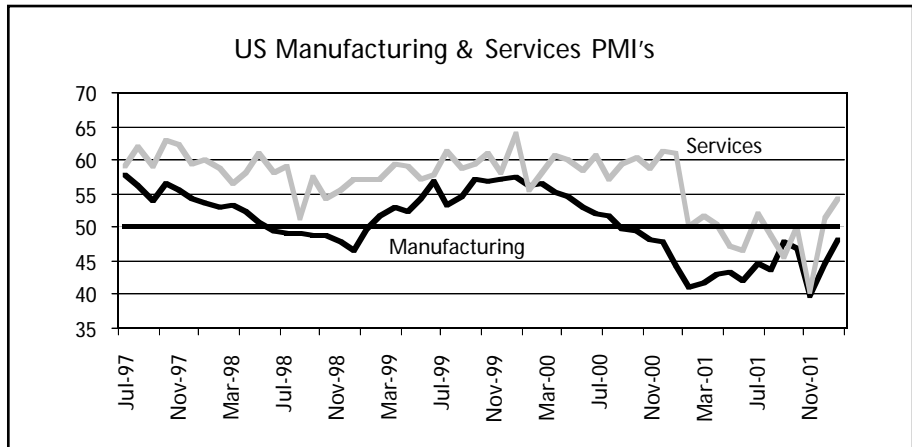
## US Economy

### *Economy still under pressure*

The US economy has been growing well below trend for the past 18 months and in the second half of last year experienced its first recession since 1990/91. Heading into the New Year, there are still a number of negative influences at work. Layoffs continue to mount, income growth has stagnated, confidence is still low and industrial production continues to fall. However, there are also reasons to be optimistic.

### *But there are grounds for optim-ISM*

There are signs that the downturn has bottomed and "better than expected" economic indicators are gaining in number. The recent ISM (formerly NAPM) typifies this trend. The report not only showed improved business activity, but also had positive implications for the inventory cycle going forward. A reading of 48.2 still indicates contraction, but is the highest reading since October 2000. The index for new orders moved into positive territory and inventory accumulation trends are contracting. It is still early days but these developments do brighten the economy's near-term outlook.



### *There are a number of stimulatory forces at work*

There are a number of stimulatory forces at work in the US economy. Interest rates have been cut by 4.75%. The lagged effects of this will be felt throughout 2002. Despite the collapse of "bipartisanship" on budgetary policy, the economy is set to receive a fiscal stimulus, which amounts to about 1.0% of GDP. The sharp decline in oil prices will provide a considerable boost to real disposable incomes, as will mortgage refinancing. Finally, inventories are expected to start making a positive contribution to growth from Q1 onwards. After zero growth in Q1, we anticipate that the economy will move into a fuller recovery in Q2 with growth accelerating over the remaining two quarters.

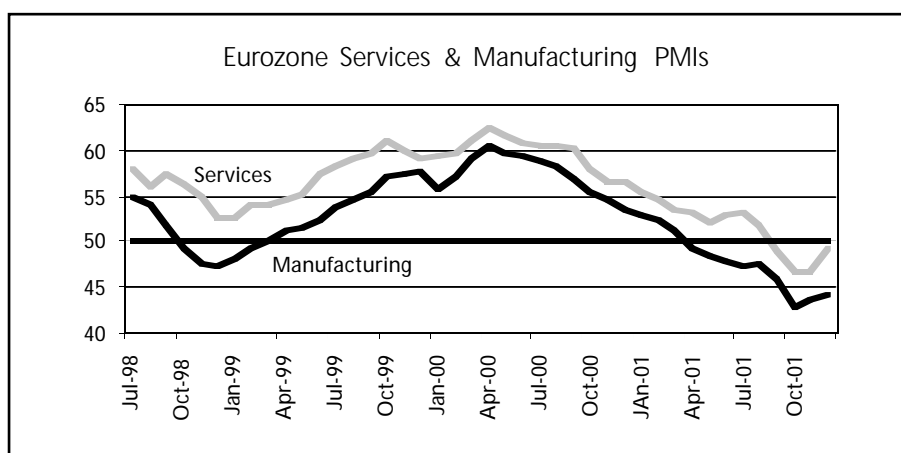
### *But recovery could be modest*

However, the risk remains that the pace of recovery could prove to be less vigorous than that experienced in previous cycles. Export growth will be dampened by the strong dollar and weaker global demand. The housing market and consumer demand have remained resilient and therefore will be unable to provide much impetus for recovery. Unemployment is expected to rise for some months to come, dampening consumer spending. Finally, investment should recover but compared to the boom of the late 90's growth in this sector will be subdued.

## Eurozone Economy

### *Growth well below trend*

The eurozone economy has been growing well below trend since early 2001. The much weaker global environment had quite a negative impact on industrial activity and also dampened export demand. Domestic demand was unable to withstand external shocks and consumer and government spending were weaker than anticipated. Tax cuts helped to underpin consumer spending earlier in the year but momentum faded as higher inflation and rising unemployment eroded spending power. Similar to other main economies, there was also a marked deterioration in investment activity.



### *Weakness to prevail for now*

The eurozone economy has entered 2002 with little momentum. Recent indicators suggest that the scale of contraction in the industrial sector is easing. However, PMI surveys are still at levels consistent with contraction. Sentiment surveys have also improved and consumer confidence remains at reasonably high levels. Despite this, the threat of further lay-offs poses a risk to spending. Growth in the first quarter is likely to be close to zero and even if activity picks up over the course of the year the average growth rate for 2002 is expected to be no more than 1.5%.

### *Sluggish recovery expected in Q2*

Thereafter, we expect a pick-up in the pace of activity. Consumer spending will be boosted by a marked drop in inflation and lower interest rates. Driven up by higher food and energy prices, inflation in the eurozone averaged 2.6% last year. We expect a significant improvement this year with the average inflation rate forecast to fall to 1.6%. Stocks should start to be rebuilt as the inventory rundown comes to an end and export demand should pick-up as the global economy starts to recover. Thus, by H2 2002, the eurozone economy should be growing at an annual rate close to trend growth.

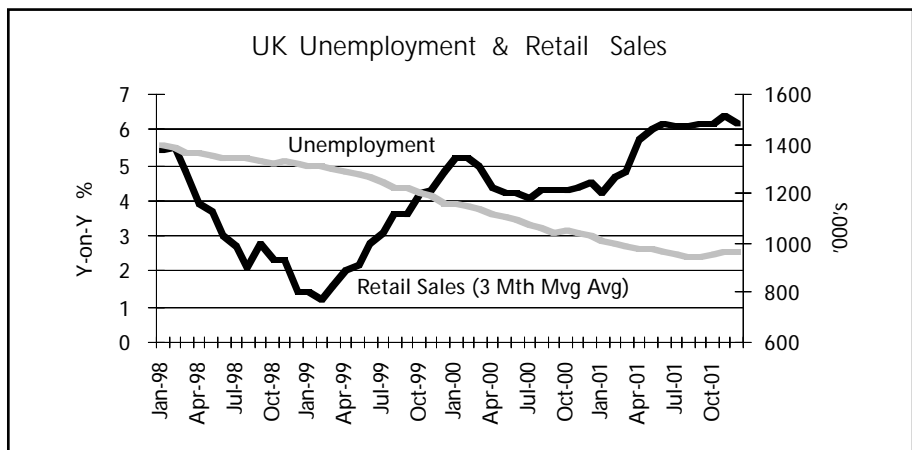
### *Fiscal policy little scope for stimulation*

The scope for fiscal policy to support higher growth is limited by the terms of the Stability and Growth pact. The budget deficit for the eurozone in 2002 is expected to be 1.5% of GDP, which suggests that there is room for manoeuvre without breaching the terms of the pact (deficit to remain below 3.0% of GDP). However, the difficulty is that individual country deficits are not uniform. France and Germany, who probably require the most stimulation, are already forecast to have budget deficits in excess of 2.5% of GDP for this year.

## UK Economy

*Two-speed economy makes UK the best of the bunch*

It is estimated that the UK economy grew by 2.5% last year, the strongest growth rate amongst the main economies. The primary reason for this out-performance was the buoyancy of consumer demand, which was underpinned by the sharp reduction in interest rates and tight labour market conditions. The housing sector also enjoyed a good year with construction output up 1.5% in Q3. The services sector slowed, but output was still up 0.6% in the third quarter. There were, however, areas of weakness. The most notable were agriculture, which was affected by the impact of foot and mouth, and manufacturing which was badly hit by the decline in the ICT sector and the strength of sterling. There was also a marked decline in the demand for exports as the global economy slowed. Furthermore, there was a sizeable fall-off in investment growth over the course of the year.



*Economy could lose some momentum in Q1*

Unemployment has started to edge upwards which could dampen consumer spending in the months ahead. This may cause the economy to lose some momentum in the opening quarter. However, we expect the UK economy to outperform again in 2002. The manufacturing sector will continue to be a major drag with surveys showing little sign of a near-term improvement. While the latest survey evidence from manufacturing sectors in the US and Europe showed signs of a stabilisation in conditions, there was a further deterioration in the UK.

*But positive growth forces will remain in place*

However, any deceleration in activity should prove to be short-lived with positive growth forces firmly embedded in the economy. Interest rates are at a 40-year low, and while the BoE has likely hit the bottom at 4.0%, we do not expect rates to rise for the foreseeable future. As government spending increases, through its commitment to health and education programmes, fiscal policy will also be supportive. Inflation is running at exceptionally low levels and the outlook going forward is very favourable. Low interest rates and low inflation will provide a boost to growth in real personal disposable income.

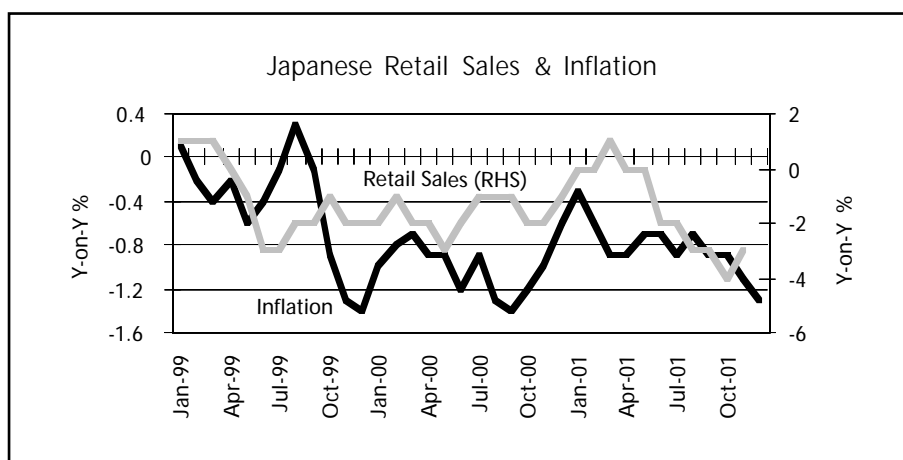
Given the stimulatory nature of both monetary and fiscal policy, we expect growth in the UK to average 2.0% this year. The economy will remain on a dual track though, with domestic demand, most notably consumer and government spending, offsetting another poor performance from the traded sector.

## Japanese Economy

### *Economy struggles with another recession*

The Japanese economy is back in recession. After declining by 4.8% (q-on-q annualised) in Q2, GDP fell by 2.2% in the third quarter. The economy is expected to contract by 0.4% in 2001, down from growth of 2.2% in 2000. The latest Tankan sentiment survey (December) gives little indication of any imminent recovery. The key diffusion index for large manufacturers deteriorated further compared to September, and a further downturn is likely in the first quarter.

Japan is faced with a myriad of problems. The yen is overvalued relative to economic fundamentals, the banking system is swamped with bad debts, unemployment is rising and the deflation problem is deepening. The y-on-y inflation rate has been consistently negative since Q3 1999. Falling wages and increasing job uncertainty mean that this trend is likely to stay in place for some time to come. Unemployment has risen to a record 5.5% and conditions are turning more severe.



### *Little hope of recovery on horizon*

The domestic economy is unlikely to pull out of recession until the deflationary trend can be halted. Hopes of a recovery have been pinned on the export sector (hence the authorities willingness to let the yen slide against other major currencies). There are tentative signs that last year's downturn in the export sector could have been halted. However, the government needs to tackle the problems which are deep rooted in the economy. The government has been slow to implement its reform plans, which include measures to encourage banks to dispose of non-performing loans. Bankruptcies continue to rise, even amongst those who have had creditors approve their rehabilitation plans. To help stimulate the economy, the government has compiled yet another package of budgetary measures but is constrained by the heavy debt burden that it is already carrying.

### *BoJ stays under pressure*

The BoJ has come under considerable demand to ease monetary policy further. With interest rates already at zero, it is under pressure to extend its quantitative easing measures. At its policy meeting in January the central bank stated that it was keeping its target level of outstanding current account deposits at the level decided at the December meeting. It did, however, announce an increase to the amount of outright government purchase that it plans to make. The measures, however, do not appear to be having any effect and the demand for credit continues to fall.

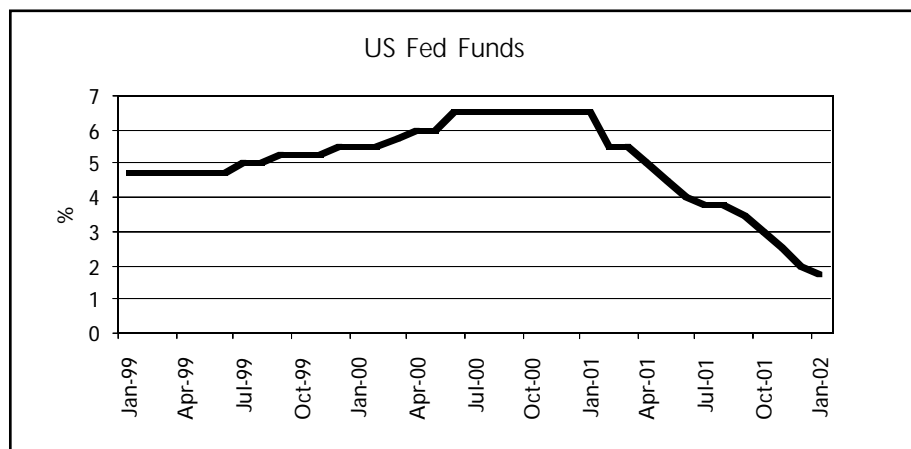
## Interest Rates

### *2001 characterised by aggressive easing*

2001 was characterised by aggressive central bank easing and steep interest rate curves. Rates were cut by 4.75% in the US, 2.0% in the UK and 1.5% in the eurozone. Japan implemented additional quantitative easing measures. With the global economy still in a precarious position and inflation well behaved, we believe that some further easing is in the pipeline.

### *Further cuts in the pipeline*

Last year, the Fed was quick to respond to the sharp downturn in US economic activity, reducing rates from 6.0% to 1.75%. In his most recent policy steer, Chairman Alan Greenspan acknowledged that there are tentative signs of an economic recovery and feels that there are reasons for concluding that the long-term picture remains bright. However, in the short-term, the economy still faces significant risks. Against this background, we expect the Fed funds rate to be cut by a further 0.25% to 1.50% at the end January Fed meeting. Policy is then likely to be put on hold until economic data indicate that a recovery has firmly taken hold. We do not expect this to happen until Q2. Even then, with economic recovery likely to be moderate and inflation expected to be subdued (allowing the Fed to keep growth as its key focus), there should be no immediate urgency about reversing recent interest rate cuts.



### *Key issue for the Fed will be the strength of the recovery*

We do not expect the Fed to move into tightening policy until the second half of the year, by which time the expected economic recovery should have gained momentum. At that point rates will have been at a 40-year low for well over six months and there is a risk of moderate tightening going into the end of 2002 and into 2003. We expect US official interest rates to be close to 3.0% by year end or early in 2003 but this is contingent on a sustained recovery. We would caution that there is still a huge degree of uncertainty surrounding the outlook for the US economy. Over the course of this year growth will be supported by a number of positive factors. However, there are negative influences that could dampen their impact, leaving only a moderate, rather than vigorous, recovery. These are outlined in our section on the US economy. If a rebound in activity does prove to be unsustainable or anaemic, then the Fed will leave rates lower for longer.

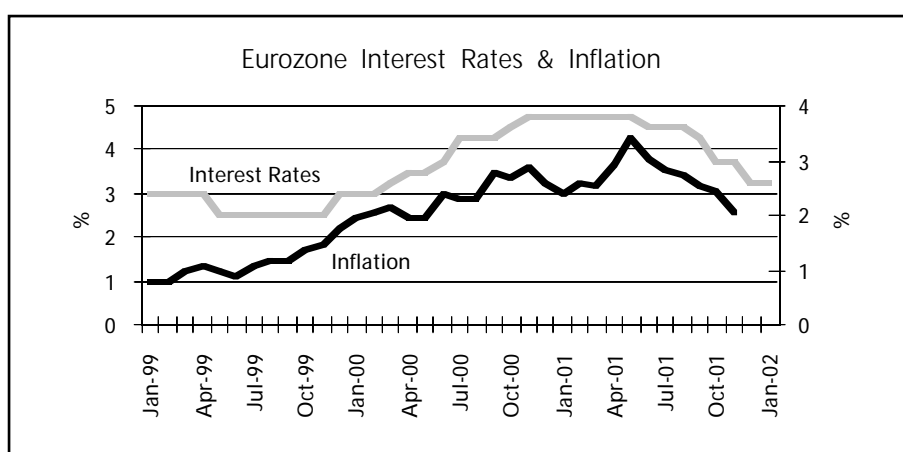
### *ECB steps up action as downturn accelerates*

Despite last year's sharp slowdown in economic activity in the eurozone, the ECB maintained a largely unchanged policy stance during the first eight months of 2001. Action on rates was severely constrained by a higher than expected inflation outturn and the central bank's strictly adhered to its 2.0% price stability mandate. As inflation pressures eased, the ECB

became more aggressive, cutting rates by 1.0% in the period September-November. The refi rate finished the year at 3.25%.

*Inflation to offer scope for further ECB easing*

Headline inflation in the eurozone is currently at 2%. Lower food and energy prices mean that the headline rate should fall to below 1.5% by mid year, while the core rate should fall to 1.0%. The last time inflation was this low was in 1999 when the ECB cut rates to 2.50%. We do not expect the ECB to be as aggressive this time round but the fall in inflation should provide scope for a reduction to 2.75%. We expect a reduction to this level to come by the end Q2. With eurozone growth remaining below potential for much of 2002, rates are likely to be put on hold for a considerable period of time thereafter.



*Sluggish growth to keep ECB inactive*

The ECB will wait for an upswing in economic activity in the eurozone to become fully established. With the eurozone following the US into recovery it is likely to be well into the second half of the year before this happens. Therefore, it may be early 2003 before the ECB begins to hike rates. Slower to cut, the ECB will also be slower to hike and we expect 3-month rates to finish the year around 3.0%. This is much more optimistic than the general market view, which sees interest rates close to 4.0% by year end, indicating a 0.50% hike in the second half of the year. Given the current economic climate, we feel this is overly aggressive.

*BoE done and dusted on UK rates*

Despite expectations of lower rates in the US and UK, the window of opportunity for further cuts in UK rates appears to have closed back in early December. At this point, further easing would only exacerbate the growing imbalances in the economy. The debate regarding the UK now centres on the timing of a rate hike. While the domestic economy remains robust, there are still concerns about the state of the manufacturing sector. Therefore, rates are likely to remain on hold for the coming months but once the global recovery takes hold the BoE will quickly move into a tightening mode. This is likely to come early in H2 with the BoE likely to be the first major central bank to tighten. However, a combination of a below target inflation rate, a higher unemployment rate and a moderation in consumer spending (though not too rapid as lower interest rates continue to support the appetite for credit) should argue against overly aggressive tightening. By the end of the year we expect the BoE to have taken back 0.75-1.0% of its 2.0% easing in 2001.

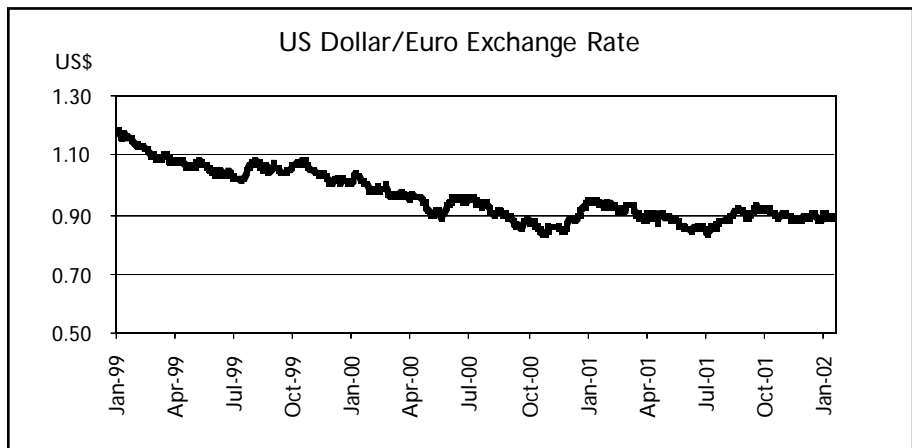
## Exchange Rates

### *Where to now for the euro?*

With the successful launch of the euro notes and coins greeted with a general sense of euphoria around Europe, the euro started the year on a strong note, gaining ground against the US dollar, sterling and yen. However, its gains proved to be short-lived and the euro is struggling to hold a \$0.88-\$0.90 range. There has been much debate about whether or not the physical presence of the euro would have an impact on fx markets. There is a view that the transition would increase investor confidence, thereby providing the basis for a rally in the year ahead. While there are some potential positives, on balance, we feel that the changeover will be of little fundamental benefit to the euro

### *Central banks talk of increased reserves*

A smooth transition for the euro was always important and its increased credibility as a result will go some way towards helping it to become a major reserve currency. Worldwide, the euro accounts for only a small percentage of reserves, with the dollar still the dominant choice (according to the latest BIS statistics 76% of total reserves are in dollars). This is most notable in Asia. China, which has the world's second largest holding of reserves, has already hinted that it intends to move a greater proportion of its \$200 billion into euro. However, monetary authorities by their nature are secretive and cautious and it is difficult to predict what they will do with their reserves. Some rebalancing of holdings should boost the euro but the impact should be little more than transitory.



### *Outflows of hot money have been depressing the euro*

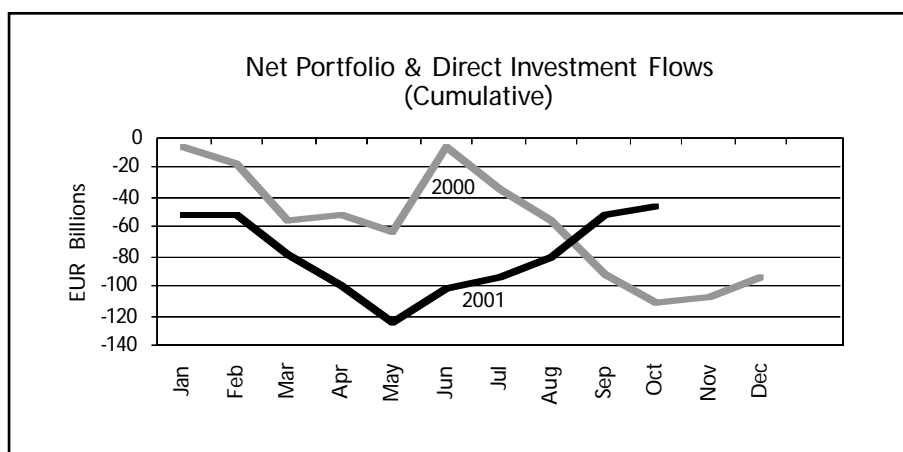
Another possible benefit being put forward is the issue of Europe's "hot money". A study by a German university estimates that €100 bln has left the eurozone since the euro's creation in January 1999. Much of this has come from Germany and has been converted mainly into dollars amid fears that the new currency would not be a stable one. With EMU currencies no longer legal tender this practice should cease. While both of these factors seem to offer some hope to the euro there are insufficient arguments for a sustained rally.

By mid-January the hype about the notes and coins was over and fundamentals resurfaced. The euro has been a reality for fx markets for the past three years and for them the completion of the single currency project has little real significance. Since 1999, the euro has lost about 25% of its value against the dollar. The main reason for its enduring descent has been the weak performance of the eurozone economy and the persistent outflows of net direct and portfolio investment funds from Europe to the US as investors sought to

participate in the benefits of the economic success story there. In the past decade, growth in the eurozone has averaged 2.0% while the US has achieved an average growth rate of 3.5%.

*Euro fails to benefit from US woes*

Last year the flow of funds eased and the euro settled into a tighter trading range against the dollar. However, this was largely due to the correction in the high-tech industry, a sharp fall in equity values and the recession in the US. With Europe also experiencing a slowdown and the ECB slow to ease monetary policy, the euro failed to benefit to the extent that we had expected from the problems being faced by the US.



*Growth differentials now the dominant factor for dollar/euro*

With global inflation on a more even keel the main fundamental factor affecting the dollar/euro exchange rate is growth differentials. Therefore, the biggest single risk that the euro faces this year is a resurgence in the US economy. If market expectations that the US economy will swing upwards in 2002 prove correct, then capital outflows from the eurozone may pick up again. As hopes for a US recovery become increasingly aggressive there are some signs that this has started already. A return to a 4% growth rate in the US, when the ECB seems content with growth of 2%, could spell renewed problems for the euro.

The consensus view is for a modest rally in the euro in 2002. Short-term the currency may prosper, particularly if the US recovery is slow in materialising, and is less robust than markets expect. Also, a re-balancing of reserves by monetary authorities will provide some support. However, by the end of 2002 as the US economy returns to form we expect the euro to have fallen back towards \$0.85.

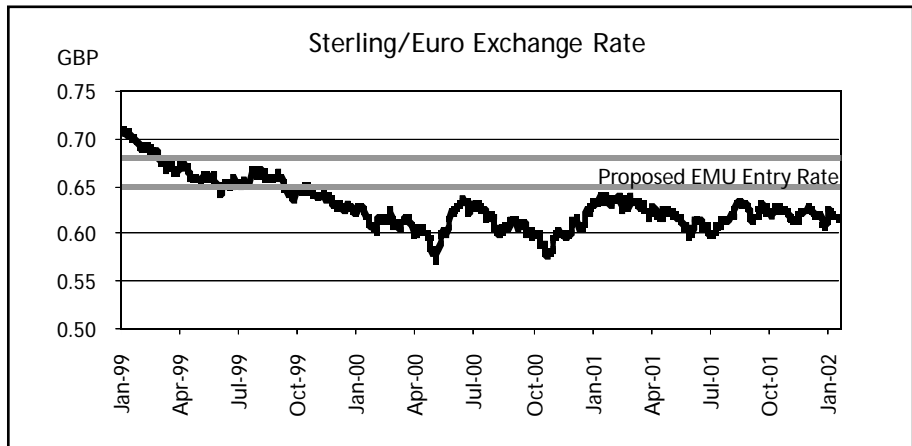
*Will the UK resist the lure of the euro*

The transition to the notes and coins had the biggest impact on the euro's relationship with sterling. In the days immediately following the introduction, sterling suffered its biggest losses since the euro's birth in 1999 as the successful launch increased speculation that the UK would rush into holding a referendum on the issue. As well as the enthusiastic acceptance of the currency, government rhetoric also supported this view. Sterling did recover as the initial europhoria faded but EMU membership is becoming an increasingly dominant issue. There are two main forces driving the sterling/euro rate; the UK's growth performance relative to the eurozone and the issue of convergence. It is generally accepted that sterling is overvalued

*Growth rewards but euro limits*

against the euro and will therefore need to depreciate sharply ahead of UK entry into EMU. With the chance of a referendum over the next 12-18 months, it is difficult to see sterling moving significantly higher against the euro over the coming year. The Labour Party's resounding victory in the last general election put an effective floor of Stg0.595/0.60 under the sterling/euro rate. Recent developments consolidated this floor above Stg0.60.

By the same token, even if a referendum were to be held there are still many obstacles to membership and until the government makes a firm commitment it is also difficult to see sterling weakening significantly against the euro. As well as convergence, the sterling/euro rate will continue to be guided by the economic growth and interest rate differentials between the UK and Europe. Both of these are currently in sterling's favour. In the absence of a strong euro rebound against the dollar, it is unlikely that the sterling/euro rate will fall below Stg0.64. Hence, we look for the sterling/euro rate to trade in a Stg0.60-0.64 range over the course of the next year, with a bias to sterling weakness. Underlying the uncertainty surrounding the issue of EMU membership is the fact the over recent months there has been little sign of convergence in UK interest rate markets.



*Yen to remain weak as economy struggles*

After trading in a Y115-125 range against the dollar for most of last year, the yen weakened sharply in the last two months of 2001 and is currently trading at 3-year lows. The yen's weakness is based on the assumption that, faced with another recession and a deflation problem, the authorities would welcome a weaker currency as a means of boosting exports and re-inflating the economy.

There may be some brief respite for the yen towards the March financial year end due to the repatriation of foreign assets back to Japan. Given the scale of the downturn in the Japanese economy the repatriation could be particularly strong this year. However, if the Bank of Japan bows to pressure to extend its quantitative easing measure to include the purchase of foreign bonds then this would put additional pressure on the currency. Any recovery in Japan is likely to lag that of the other major economies and thus we expect the yen to weaken further over the course of the coming year but downside should be limited to around Y140 against the dollar. Y140 is thought to represent a comfortable level for both the US and Japanese authorities. It is also believed to be the lowest rate that China will tolerate.

## Irish Economy

### *No hard landing in 2001*

It is estimated that Irish real GDP grew by almost 8% in real terms in 2001. Such a rapid rate of growth, though down on the average growth of 11.5% recorded in 2000, seems at odds with the perception of the Celtic Tiger economy crashing towards a hard landing last year. However, the economy experienced a number of external shocks and internal constraints, which impeded its performance in the course of the year. Thus, from a 12.7% annual growth rate in the first quarter of 2001, it is estimated that the annual rate of growth in real GDP slowed to 2% by the final quarter. We expect real GDP to grow by 3.5% in 2002.

Y-on-Y % Change	2000	2001	2002
Real GDP	11.5	7.7	3.5
Real GNP	10.4	5.0	3.0
Consumer Spending	9.9	5.5	4.0
Fixed Investment	7.0	2.0	-2.0
Exports	17.8	9.3	4.3
CPI (%)	5.6	4.9	3.7
Unemployment Rate (%)	4.3	3.7	5.0
General Govt. Balance as % of GDP	4.5	1.4	0.7

### *GDP to grow by 3.5% in 2002*

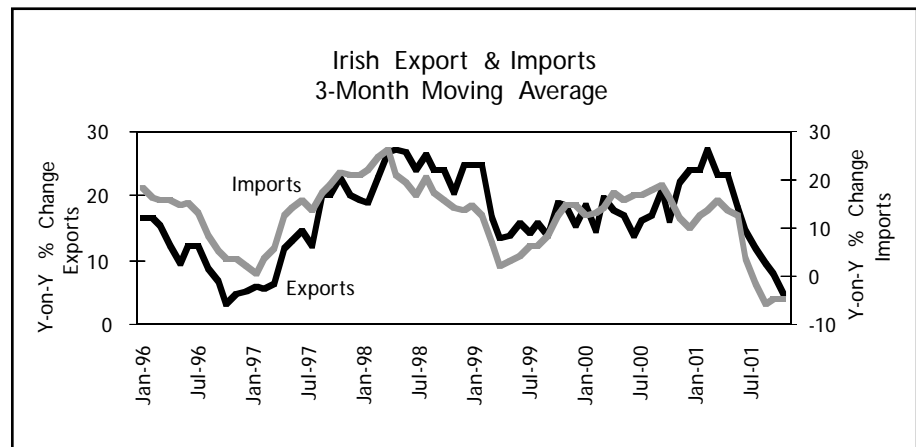
It is estimated that the growth in real GDP in calendar year 2000 of 11.5% came from a combination of a carryover of 5 percentage points from 1999 and a contribution of 6.5 percentage points from intra-year growth in 2000. In 2001, the calendar year growth rate of 7.7% was made up of a carryover of 5 percentage points from 2000 and an intra-year contribution of 2.7 percentage points in 2001 (most of which came in Q1 '01). Looking to 2002, there is no positive carryover from 2001. Indeed, the carryover effect could be negative. Our projected growth in real GDP, therefore, of 3.5% in 2002 is forecast to come exclusively from intra-year growth, much of which is forecast to come in the second half of 2002.

### *GNP to grow by 3% in 2002*

The growth in real GNP in 2001 is estimated at 5%. Significant BOP outflows in Q2 '01 and base effects created a significant difference in the estimated growth in real GDP and real GNP in Q2'01 of 7.6 percentage points. Balance of payments data for Q3 '01 have not been published so it is difficult to know if the large outflows continued after Q2'01. It is tentatively forecast that the growth in real GNP in 2002 will be about 3%.

### *Forecasts subject to wide margin of error*

It should be noted that due to data limitations and the magnitude of the trade side in Irish GDP, where imports and exports of goods and services account for over 190% of GDP, the estimation of changes in real GDP and GNP can be subject to wide margins of error. Differences in Irish economic growth forecasts of 1 to 2% therefore need not necessarily indicate a vastly different view of how the economy is expected to perform. The achievement of a growth rate (in real GDP) of over 3% in calendar 2002 would represent a considerable achievement and set the economy on course for a return to growth of 5 to 6% in 2003.



*Economy underpinned by favourable factors*

The Irish economic outlook is favourable and underpinned by a combination of positive drivers. Fiscal policy remains very supportive of growth in 2002, helped by lower personal and corporate tax reliefs. Monetary policy too remains very accommodative. Interest rates are low and could fall further while the euro remains at very competitive levels. Employment growth is also quite strong, notwithstanding the job losses in 2001. The international environment should also improve steadily in the course of 2002, which will benefit the trade sector.

*But some difficulties to be overcome*

Difficulties remain, however. Infrastructural bottlenecks will continue to impede non inflationary growth while FDI and tourism flows will be slow to recover. The Irish inflation rate is forecast to average 3.7% in 2002, down from 4.9% in 2001. After a period of rapid economic growth, which brought full employment and a tight labour market, the growth in wage incomes accelerated in recent years. Future wage developments must be linked to productivity gains if the economy is to return to a sustainable medium term growth rate of 5% or more in 2003 and beyond.

## Interest Rate Risk Management

In this issue we continue our theme of the management of Interest Rate Risks. The principle drivers of longer term interest rates are found in the Bond (or Gilt markets). These are the markets in which governments and larger corporates raise finance by issuing their paper in exchange for funding.

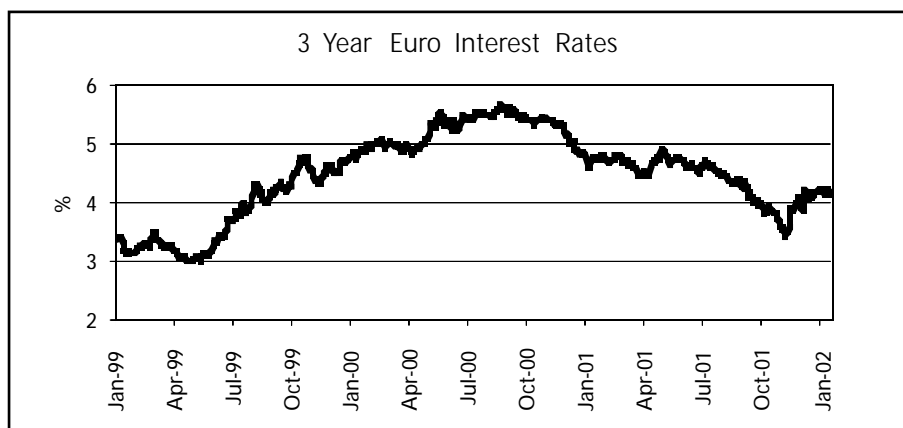
The forces of supply and demand are very much in evidence in this market - as the supply of longer term paper increases, the price on the paper falls forcing yields up i.e. there is more competition for the available funds and consequently government or larger corporates pay more for these funds.

The knock on effect of this is seen in the interest rate swap (IRS) markets – this is the product used to swap a floating rate for a fixed rate or vice versa. If the yields on Government Bonds (Gilts) rise, the swap rate consequently will also rise.

*So what are market conditions like at present?*

There is scheduled to be ongoing and large bond issuance by both European and US governments in the coming six months. The deciding factor on the yields on these issues will be determined by the markets ability to absorb these issues without an excessive draining of liquidity from the market.

At present there is excess liquidity in the market. However, it is felt at the time of writing that the ongoing requirement of governments to fund will lead to higher longer term rates. To put this in context, the 3 year euro fixed rate has moved in excess of 0.25% since the start of December 2001.



In light of the foregoing this may be an appropriate time to review the management of longer-term debt, particularly as indications point to a steeping of the yield curve in the near future.

If you wish to discuss this article further please contact your service team.

**Brian Colgan,**  
**Head of Commercial Treasury**

# Economic Diary

<b>Week 1</b>	Jan 21	UK	Money Supply M4 (Dec)
	Jan 22	US	Leading Indicators (Dec)
		Eurozone	Industrial Production (Nov)
		Eurozone	Harmonised CPI (Dec)
	Jan 23	UK	Minutes of MPC Meeting (Jan)
		UK	CBI Industrial Trend Survey (Jan)
	Jan 24	Eurozone	ECB Monthly Bulletin (Jan)
		US	Greenspan Testifies to Senate Budget Committee
	Jan 25	UK	GDP Provisional (Q4)
		Italy	CPI Provisional – 12 Cities (Jan)
<b>Week 2</b>	Jan 28	Euro	Money Supply – M3 (Dec)
		Germany	IFO Business Survey (Jan/Dec)
	Jan 29	US	Durable Goods Orders (Dec)
		US	Consumer Confidence (Jan)
	Jan 30	US	Real GDP – Advance Q4
		US	FOMC Meeting (Jan)
	Jan 31	Germany	Provisional CPI (Jan)
		US	Employment Cost Index Q4
		US	Chicago PMI (Jan)
		US	FOMC Minutes (Dec)
	Feb 01	Eurozone	Flash estimate Eurozone CPI (Jan)
		US	Non-Farm Payrolls (Jan)
		UK	Manufacturing PMI (Jan)
		US	ISM/NAPM Survey (Jan)
		US	U of Michigan Consumer Sentiment (Jan f)
<b>Week 3</b>	Feb 4	Euro	Business Confidence (Jan)
		Euro	Consumer Confidence (Jan)
	Feb 5	UK	Services PMI (Jan)
		US	NAPM Non-Manufacturing Survey (Jan)
		Euro	Unemployment Rate (Dec)
	Feb 7	UK	Industrial Prod. & Manuf. Output (Dec)
		UK	BoE Meeting
		Euro	ECB Meeting
<b>Week 4</b>	Feb 11	UK	Producer Prices (Jan)
	Feb 12	UK	Retail Prices (Jan)
	Feb 13	US	Retail Sales (Jan)
		US	Greenspan Testifies before Senate Banking Committee
		UK	BoE Inflation Report
	Feb 14	Euro	ECB Monthly Bulletin (Feb)
	Feb 15	US	Producer Prices (Jan)
		US	Industrial Production & Cap Utilisation (Jan)
		US	U. of Michigan Consumer Sentiment (Feb p)

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