

MARCH 2008

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the bulletin

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The euro is overvalued against the dollar

The dollar is undervalued in Europe...

...but few appear concerned.

The US dollar has rallied a little in the past few weeks but its decline against the major currencies over the past twelve months is startling; it has fallen by 20% against the Swiss franc, by 18% against the yen and by 17% against the euro. Indeed, the latter has risen by some 30% against the Greenback over the past two years and by over 12% against a basket of the major currencies. Such moves may dampen Irish exports (18% go the US) and squeeze export margins, but also increase Irish spending power in the US, be it for assets such as property or for consumer items, so it essentially represents a transfer of purchasing power from exporters to consumers.

The fact that most Irish visitors to the US find shopping to be cheap implies that the dollar is now undervalued against the euro, at least on the basis of purchasing power parity (PPP). This theory, one of the oldest in economics, states that the same basket of goods in two countries should cost the same when converted into a common currency. Research also lends some support to the view that foreign exchange rates eventually return to PPP rates, which can be viewed as 'fair value' for a currency.

Unfortunately, estimates of PPP differ but most studies put the euro's PPP rate against the dollar in a relatively narrow range, between \$1.10 and \$1.20, which implies that the euro is currently at least 30% overvalued. If so,

one might expect the euro to fall against the dollar. Again, things are not that simple as research shows that currencies can diverge from 'fair value' for years, so PPP is not very good as a short term forecasting tool.

Nevertheless, it is noticeable that the consensus forecast is indeed for a rally in the dollar this year, to \$1.40 by end-December. We share that view, in directional terms at least, but there is a policy vacuum surrounding the dollar which poses further downside risks, in that policy-makers on both sides of the Atlantic seem unconcerned about the dollars' value. From the US perspective, a weak dollar has proven beneficial in that exports are the only major component of the US economy showing any serious growth. In Europe, the euro's strength has proved beneficial from an ECB viewpoint, in that it has partially offset rising commodity prices and so helped to limit the recent rise in inflation. This leaves the fifteen respective member states of the euro, where opinions differ, and where there is no body to voice concern let alone actually intervene, even if there was a unanimous view that the euro is too strong. Contrast this with the situation in Asia, where many governments have bought dollars in recent years to prevent too-rapid an appreciation of their own currencies.

Dr. Dan McLaughlin
March 2008

MPC to lower interest rates again

Tighter monetary conditions...

...and slowing economic growth...

...means rates have further to fall.

Inter-bank interest rates have risen over the past month, with 3-month Libor almost 30bps higher at 6%. This is 75bps above the current level of official interest rates and is an indication of renewed strains in the money market. Swap rates have risen as well over this period, with the 3-year rate some 30bps higher at around 5.15%. Monetary conditions have thus tightened over the past month, although a further decline in the value of sterling has provided some partial offset.

The Bank of England (BoE) has continued with its gradual approach to lowering interest rates, keeping the Bank Rate steady in March following its 25bps cut in February, which in turn came two months after the first quarter point reduction in December. This caution in reducing rates reflects the Bank's need to gauge the balance of two risks to the inflation outlook that exist at present, as its Governor, Mervyn King, explained recently to the Treasury Select Committee (TSC) of the UK Parliament.

The first is the risk that a sharp slowdown in the economy this year, driven by the credit crunch, pulls inflation down below its target (of 2%) in 2009. The second is that rising inflation - inflation has accelerated to 2.5% from 2.1% over the past couple of months and is expected to rise further in the near-term, to around 3%, on account of higher domestic gas and electricity prices - enters the expectations of those setting prices and pay in the economy, resulting in inflation persisting above its target.

The indications from the Bank of England are that it will continue to lower interest rates. Although the slowdown in the economy to date has been modest - the available data suggest real GDP grew by 0.5% in the first quarter of this year, only

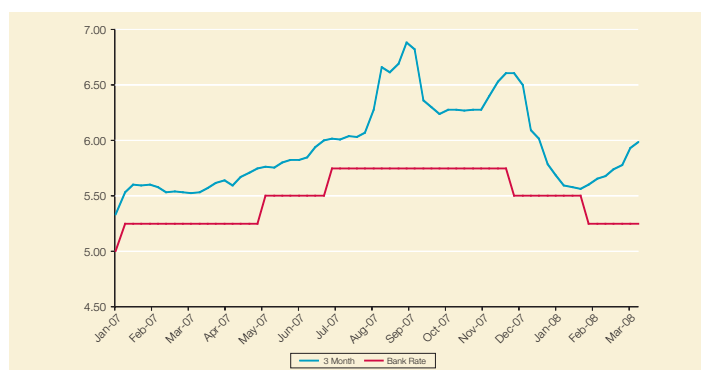
slightly less than the 0.6% increase in Q4 albeit again below-trend - the Bank expects a sharper deceleration in activity over the remainder of this year, which argues for a further easing of interest rates. In addition, tighter monetary conditions on foot of the renewed rise in market interest rates will have to be offset by lowering official rates, as Mervyn King acknowledged in his testimony to the TSC. As regards inflation, and notwithstanding its concerns outlined above, the BoE still expects it to fall back towards 2%, starting later this year.

The market expects the Bank Rate to be cut to 5% by May at the latest, with a further quarter point reduction expected by August and some additional easing - about 25bps - expected over the following 3-6 months. This is broadly in line with our own view and would take the Bank Rate down to around 4.5%, which is below its average of 5.2% over the past decade and as such appropriate given the economy is expected to grow below trend over this period. This expected trajectory for official interest rates should allow swap rates to fall back again from their current levels - of 5.1% to 5.25% out to 5 years - with a return to a range of 4.75% to 5% likely over the coming months.

Sterling has weakened further against the euro over the past month, falling to a new low of over 79p in mid-March. With rate cuts in the UK coming sooner than any such moves in the Euro Area, sterling is likely to remain under pressure on the exchanges. We still believe it will strengthen during the course of this year as the ECB begins lowering interest rates, though the longer the ECB delays in doing so the more delayed will be any recovery in sterling.

Michael Crowley

UK Interest Rates



euro zone

ECB not for turning - yet

Central Bank insists current level of interest rates appropriate...

...though economy is slowing...

...which will eventually force its hand.

Strains have re-emerged in the inter-bank market over the past month. Euribor rates have risen, with the 3-month rate currently some 30bps higher at just over 4.70%. This has put upward pressure on swap rates, which in the three year area have increased by over 35bps to almost 4.2%, though the market has pared back expectations for ECB rate cuts which has also put also upward pressure on bond yields and, hence, swap rates. The euro strengthened through the course of the month, both against the dollar and on a trade-weighted basis. Rising market interest rates and a strengthening currency have resulted in a tightening of monetary conditions recently, which will tend to reinforce the slowdown in the rate of economic growth that is currently underway.

The economy grew by 0.4% in the final quarter of 2007, about half the pace recorded in Q3. Moreover, all of the increase in real GDP was due to net exports, with domestic demand flat over the period. Notably, real consumer spending posted an outright decline in Q4, falling by 0.1%, though the negative effect of this on overall growth was offset by another sizeable increase in investment. Meanwhile, the available indicator data suggest the pace of growth slowed further in the first quarter of 2008. In particular, the Purchasing Managers surveys of activity in the manufacturing and services sectors point to an increase in GDP of about 0.3%, which would mark the first back-to-back quarters of below-trend growth since late 2004/early 2005.

In the light of the slowdown in activity, the ECB has revised downward its forecasts for economic growth in 2008 and 2009, to 1.7% and 1.8% respectively from 2.0% and 2.1% projected in December. However, notwithstanding slower growth than previously expected, the ECB has revised upwards its forecast for inflation in each of

these two years, to 2.9% and 2.1% from 2.5% and 1.8%, mainly reflecting "significant additional increases in food and energy prices".

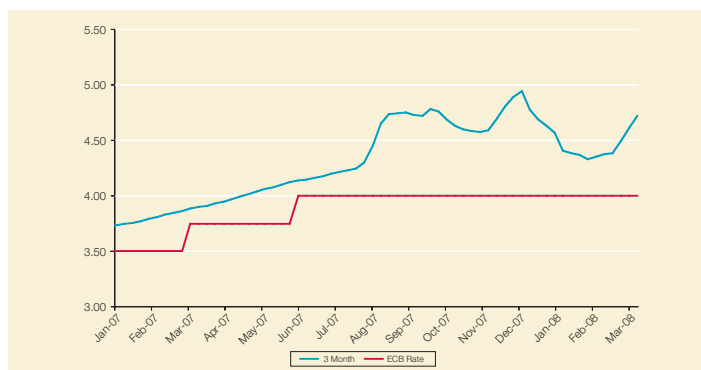
The ECB kept its key interest rate unchanged at 4% in March. It noted that the available information confirmed "the existence of strong short-term upward pressure" on prices as well as "upside risks to inflation over the medium term". It also noted that the "incoming macroeconomic data point to moderating but ongoing real GDP growth", though it reiterated that there are downside risks to the outlook for economic activity. Notwithstanding this, it said its "current monetary policy stance" (i.e. the current level of interest rates) will contribute to achieving its "primary objective" of maintaining low inflation.

The market has pared back expectations for ECB rate cuts this year. It is now only *fully* priced for a 25bps reduction - and then not until September - though it is attaching a relatively high probability to rates falling by 50bps by year-end. This is a marked change from early February, when the market had priced in a cumulative 75bps reduction in rates by December with some probability attached to them being cut by 100bps over this period.

Against a background of slowing growth, tightening monetary conditions and on-going strains in the money market, we expect the ECB to lower official interest rates. We are still penciling in a cut in Q2 and think this is now most likely to occur in June, though given the hard line stance being adopted by the ECB at present we accept it may not move until later than this. In that event, any weakening of the euro would probably be delayed, though we still expect the single currency to lose ground over the course of this year.

Michael Crowley

Euro Interest Rates



Fed on the ball

Amid turmoil in markets...

...Fed provides significant liquidity...

...and cuts key interest rate by 75bps...

...with a final 50bps likely by mid-year.

Amid renewed turmoil in markets over the past month, which resulted in the effective rescue of investment bank Bear Stearns, the Fed announced a series of measures to address "heightened liquidity pressures in term funding markets". It also lowered its key policy interest rate, the federal funds rate, by a further 75bps - to 2.25% - to bring the cumulative reduction since the start of this year to 200bps. It said the outlook for the economy had weakened, as growth in consumer spending slowed and the labour market softened, and noted that financial markets remained under "considerable stress" with the resulting tightening of credit conditions likely to weigh on growth over the coming quarters.

The economy grew at an annualised pace of just 0.6% in the final quarter of last year. The indications are that the first quarter of this year will be no better and could be worse, which means there is a chance the economy actually contracted over this period. The housing market remains especially depressed and another sizeable fall in housing output will act as a considerable drag on growth again in Q1. More significantly, consumer spending has slowed noticeably. Real consumer spending failed to grow in three of the four months to January and there is a danger that spending will post an outright decline in the first quarter, though in any case growth will certainly be considerably slower than the 2.3% rate recorded in Q4.

A number of factors are weighing on consumer spending, including high energy and food prices, falling house prices and, most importantly perhaps, falling employment, with total employment declining in both January and February. Businesses have also become more cautious about making investments, judging by the recent trend in orders for capital goods. One bright spot, which may yet prevent the economy from contracting in the first quarter, is exports, which are

benefiting from still relatively strong global growth and the weak dollar.

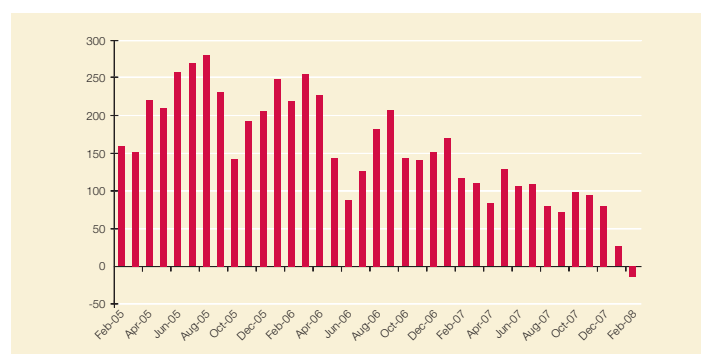
Although the Fed sees the economy remaining weak through the first half of this year, it expects conditions to improve in the second half. It believes the accommodative monetary policy it has put in place will support stronger growth over this period. Moreover, it also believes the government's fiscal stimulus package will also boost spending over the latter part of the year.

Though it sees some improvement later this year, the Fed believes there are still downside risks to growth. This suggests it may lower interest rates even further, though at this juncture we think any further easing will be limited. The fed funds rate in real (i.e. inflation adjusted) terms is now very low at effectively 0%, given the current nominal fed funds rate of 2.25% and core inflation of just over 2%, another indication of the extent to which the Fed has eased monetary policy in recent months. The statement accompanying the 75bps rate cut in March also sounded a more cautious note about inflation, saying uncertainty about the outlook had increased given some indications of a rise in inflation expectations in the economy.

We expect the Fed to cut rates by a final 50bps between now and June, either a half point move in April or a quarter point reduction at each of the April and June meetings. In any case, we believe the bulk of the rate cutting is now behind us, which means there is limited scope for bond yields/swap rates to fall much further and indeed they are more likely to trend higher from here. An end to the rate cutting and signs of some revival in economy, together with an easing of euro area monetary policy, should contribute to some strengthening of the dollar over the course of the year.

Michael Crowley

Monthly Change in Employment (000's, 3mma)



swap rates

Swap Rates

Swap spreads still elevated...

...and rate expectations have changed.

Swap rates across the major currencies continue to be buffeted by countervailing forces. Short-term interest rates have fallen in the US and the UK and are expected to fall further, which is exerting downward pressure on swap rates, but interbank rates have risen sharply again of late, so increasing the perceived risks of dealing with a bank as a counterparty rather than a Government.

The impact of the latter effect can be seen very clearly in the UK, where 5-year swap rates have traded around 5% since the turn of the year, despite a 50bps fall in Government bond yields to 4%. The reason is that the swap spread has risen steeply over the same period by around 50bps, to record levels in excess of 100bps. In essence, then, risk is being re-priced so swap rates are now trading at higher levels for any given government bond yield. This may not change substantially in the short term, and we therefore expect 5-year swap rates in sterling to continue to trade around 5%.

The situation is broadly similar in the euro area, in that swap spreads also moved wider, albeit less aggressively, and have rallied of late; the 5-year swap spread is around 50bps from a high of 70bps in early March. In this case, market expectations regarding the likely pace of ECB easing have also changed, however, with the timing of rate cuts pushed further into the future. This has

prompted a rise in bond yields, with the result that 5-year swap rates have moved to the top of the 3.90% - 4.20% range seen in recent months. The euro economy is weakening, nonetheless, and we therefore expect rate expectations to shift again, precipitating a fall in swap rates to the lower end of that range.

Interest rate expectations have also shifted in the US, with the market now priced for a cycle-low of 1.75% rather than sub 1.50%. This has pushed bond yields higher, offsetting a decline in swap spreads, so pushing the 5-year swap spread back up to around 3.50% from a low of 3%. The former is in line with our forecast and we envisage little change in the short term.

	Euro		Sterling		Dollar	
	June 08	Sept 08	June 08	Sept 08	June 08	Sept 08
2 year	3.75	3.60	4.90	4.90	2.60	2.75
5 year	3.75	3.75	5.00	5.00	3.50	3.75
10 year	4.25	4.25	5.00	5.00	4.25	4.50

forecasts

Exchange Rates

	Current	End-June	End-Sept	End-Dec
		2008	2008	2008
EUR / USD	1.5810	1.50	1.40	1.40
EUR / GBP	0.7911	0.77	0.75	0.75
USD / JPY	100.07	105	110	110
GBP / USD	1.9956	1.95	1.87	1.87

Official Interest Rates

	Current	End-June	End-Sept	End-Dec
		2008	2008	2008
Fed Funds	2.25	1.75	1.75	1.75
ECB	4.00	3.75	3.50	3.50
UK	5.25	5.00	4.75	4.50

Swap Rates: 5-year

	Current	End-June	End-Sept	End-Dec
		2008	2008	2008
US	3.48	3.50	3.75	3.75
Euro Zone	4.19	3.75	3.75	3.75
UK	5.11	5.00	5.00	5.00

GDP and Inflation (%, annual average)

	2007		2008	
	GDP	Inflation	GDP	Inflation
US	2.2	2.9	1.4	3.1
Eurozone	2.6	2.1	1.6	2.6
UK	3.0	2.3	2.0	2.5

economic diary

April

Date	Eurozone	United States	United Kingdom
1	PMI Manufacturing, German Unemployment	ISM Manufacturing, Construction Spending, Vehicle Sales	CIPS Manufacturing Index
2	PPI	Factory Orders, ADP Report	Mortgage Approvals, CIPS Construction Index
3	PMI Services, PMI Composite, Retail Sales	ISM Non-Manufacturing, Jobless Claims	CIPS Services Index
4	German Factory Orders	Payrolls Report	
7	German Industrial Output	Consumer Credit	
8		Minutes of March 18 Fed Meeting	
9	GDP (Q4, final)	Wholesale Inventories	Industrial Output
10	ECB Meeting, French Industrial Output	Trade Balance, Jobless Claims	MPC Meeting, Trade Balance
11		Consumer Confidence, Import Prices	
14	Industrial Output, French Business Sentiment	Retail Sales, Business Inventories	PPI
15	New Car Registrations, German ZEW Index	PPI, Empire Index, TIC Report, NAHB Housing Index	CPI, BRC Retail Sales Monitor
16	CPI	CPI, Fed Beige Book, Industrial Output, Housing Starts	Labour Market Statistics
17	ECB Monthly Report, Trade Balance	Jobless Claims, Philly Fed	
18	Construction Output		M4
21	PMI 'Flash' Estimates		Rightmove House Prices
22	Budget Deficit/GDP Ratio	Existing Home Sales	
23	French Consumer Spending	Mortgage Applications	MPC Meeting Minutes

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