

4th February 2010

Interest Rates

UNITED KINGDOM: The Monetary Policy Committee (MPC) left rates at 0.5% and decided not to expand the asset purchase scheme at its February meeting. This was the expected result, though there was considerable speculation about an extension of QE that could be used at the MPC's discretion. With £200bn of assets purchased, and short-term rates held at 0.5% since March last year, the Committee judged enough had been done (for now) to ensure inflation hits its target at the two year horizon.

There are still risks in both directions when it comes to the outlook. Inflation has remained surprisingly stubborn and short term noise in the data created by gyrations in energy prices and changes in tax rates is making it even more difficult than usual to discern underlying price trends. Inflation jumped to 2.9% in December, and will rise further in January, the result of VAT reverting to the 17.5% rate. This level effect will stay in the figures for a year before dropping out and should not alter inflation expectations.

There are still lingering concerns that the weak pace of the recovery may cause inflation to *undershoot* the 2% target further out. The UK economy grew by just 0.1%, well below expectations of a 0.4% rise. Whilst it's good news that the economy is growing again, 0.1% is little more than a rounding error, cautioning that the recovery is still fragile. Weak demand should ultimately lead to lower inflation. Looking ahead, we don't expect the MPC to raise rates until early 2011 lest they kill off any recovery. Deciding when, and how, to act will pose considerable challenges.

UNITED STATES: The Federal Reserve kept rates on hold at 0% to 0.25% and reiterated that rates would remain low for an "extended period". However, policymakers signalled that their ultra-stimulative policy stance may be shifting. Kansas City Fed President Hoenig dissented from the decision, objecting to the "extended period" language in the

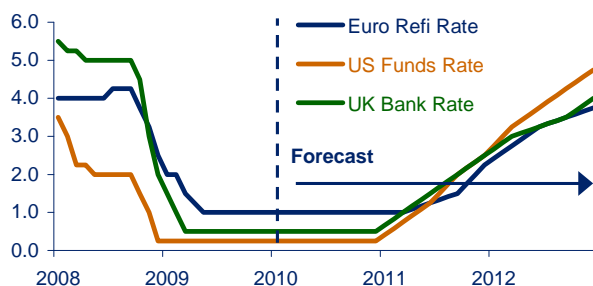
policy statement. The Committee went as far as they realistically could in winding down their liquidity programs.

News that the US economy grew at a sprightly 5.7% q/q rate (annualised) in Q4 was encouraging, but it's too early to declare that the recovery is secure. Inventory liquidation was by far the largest source of growth, accounting for about 60% of the advance. This can't form the basis of a durable upturn. The US consumer, which accounts for 70% of all spending, remains under pressure. The labour market remains in intensive care, with the unemployment rate still at c10% and income growth depressed. The recovery in asset prices has helped ease balance sheet strains, but repair work is still needed. Household wealth is c\$5 trillion higher than it was in Q1 2009, but is still \$12 trillion below its peak. We continue to expect the US recovery to be a gradual affair, and as a result don't expect the first rate rise to come until late 2010 or early 2011.

EURO AREA: As expected, the European Central Bank (ECB) decided to leave interest rates unchanged in February. The region exited recession in mid-2009, but the pace of growth is expected to have slowed in Q4. The recovery is likely to be bumpy and uneven, with many of the economies at the periphery suffering more than the core. Euro area inflation ticked up slightly to 1% in January, but remained well below the ECB's 2% ceiling. The region's labour market is still weakening, with the unemployment rate rising to 10%, the highest level for eleven years. With significant spare capacity, weak demand and a strong euro, price pressures are unlikely to re-emerge any time soon. Indeed, M3, the ECB's preferred gauge of long-term inflation trends, fell for only the second month ever in December. We expect the ECB to maintain interest rates at current lows throughout this year and into the early part of 2011.

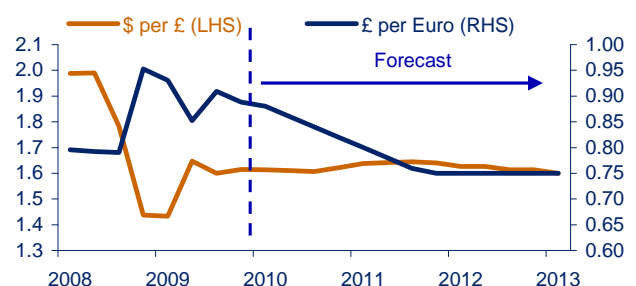
Interest Rate Forecast in %

Source: Thomson Datastream, RBS Group Economics



Exchange Rate Outlook

Source: Thomson Datastream, RBS Group Economics



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Exchange Rates

The main development over the past month was the depreciation of the euro against other major currencies. The euro fell 3c against sterling (£0.90 to £0.87) over the month and 5c against the dollar (from \$1.44 to \$1.39). The sterling-dollar rate saw its fluctuations, but there was little net movement in any direction over the month.

The euro's move lower appeared to reflect investors' growing optimism that UK and US policymakers may exit from their unusually loose monetary policy settings sooner than they had previously anticipated, making the dollar and sterling look more attractive. The weaker euro is also likely to reflect investor concerns over government debt dynamics in the region, especially in some peripheral euro economies, as evidenced by rising yields on Greek and

Portuguese bonds relative to their French and German counterparts. The emerging strains on some of these economies' public finances have further reinforced the growing divide between the economic performance of the core (Germany, France) and the periphery. Setting a single monetary policy for the euro area remains a challenge.

The outlook for the major exchange rates remains highly uncertain, reflecting the uncertainty about the trajectory of the global economy. The sterling-dollar rate appears fairly close to fair value in our view, although the euro continues to look strong. We expect the dollar and sterling to gain a little more ground against the European single currency over the medium term.

| RBS Group Economics Interest and Exchange Rate Forecasts | | | | | | | |
|--|--------------------------------|----------|---------|----------|----------------------------------|---------------|--------------|
| | EXCHANGE RATES (end of period) | | | | INTEREST RATES (% end of period) | | |
| | \$ per £ | \$ per € | £ per € | ¥ per \$ | Euro Refi Rate | US Funds Rate | UK Bank Rate |
| 2009 Q1 | 1.44 | 1.32 | 0.92 | 99 | 1.50 | 0.25 | 0.50 |
| Q2 | 1.65 | 1.41 | 0.86 | 97 | 1.00 | 0.25 | 0.50 |
| Q3 | 1.59 | 1.46 | 0.91 | 90 | 1.00 | 0.25 | 0.50 |
| Q4 | 1.61 | 1.45 | 0.90 | 92 | 1.00 | 0.25 | 0.50 |
| | | | | | | | |
| 2010 Q1 | 1.61 | 1.42 | 0.88 | 93 | 1.00 | 0.25 | 0.50 |
| Q2 | 1.61 | 1.39 | 0.86 | 94 | 1.00 | 0.25 | 0.50 |
| Q3 | 1.61 | 1.35 | 0.84 | 95 | 1.00 | 0.25 | 0.50 |
| Q4 | 1.62 | 1.33 | 0.82 | 95 | 1.00 | 0.25 | 0.50 |
| | | | | | | | |
| 2011 Q1 | 1.64 | 1.31 | 0.80 | 95 | 1.00 | 0.75 | 1.00 |
| Q2 | 1.64 | 1.28 | 0.78 | 95 | 1.25 | 1.25 | 1.50 |
| Q3 | 1.64 | 1.25 | 0.76 | 95 | 1.50 | 2.00 | 2.00 |
| Q4 | 1.64 | 1.23 | 0.75 | 95 | 2.25 | 2.50 | 2.50 |
| | | | | | | | |
| 2012 Q1 | 1.63 | 1.22 | 0.75 | 95 | 2.75 | 3.25 | 3.00 |
| Q2 | 1.63 | 1.22 | 0.75 | 95 | 3.25 | 3.75 | 3.25 |
| Q3 | 1.61 | 1.21 | 0.75 | 95 | 3.50 | 4.25 | 3.50 |
| Q4 | 1.61 | 1.21 | 0.75 | 95 | 3.75 | 4.75 | 4.00 |

| Key Central Bank Monetary Policy Meetings in 2010 | |
|---|---|
| Bank of England | 4 Feb, 4 Mar, 8 April, 6 May, 10 June, 8 July |
| US Federal Reserve | 16 Mar, 28 Apr, 23 June, 10 Aug, 21 Sept, 3 Nov, 14 Dec |
| European Central Bank | 4 Feb, 4 Mar, 8 Apr, 10 June, 8 July, 5 Aug |

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