

Interest & Exchange Rate Forecast

8th January 2010

Interest Rates

UNITED KINGDOM: As expected, the UK's Monetary Policy Committee (MPC) decided to continue along the course they charted in November, holding rates at 0.5% and completing the rest of the scheduled £25 billion of asset purchases by their next meeting. Data releases since the December decision did not warrant a policy change. Inflation ticked up slightly, to 1.9% in November, but this was consistent with expectations that inflation will rise above 3% in the short term (largely as a result of the weakness of sterling and the rise in the VAT rate), before dipping back below the 2% target before the end of 2011.

The tough decision will come in February. Looking through the expected short-term spike in inflation at the start of this year, fundamental weakness in the economy will weigh on price pressures further out. Inflation has been surprisingly sticky throughout the recession. Nevertheless, there are lingering concerns that the MPC may not have done enough to stimulate the economy so that inflation does not *undershoot* the 2% target further out. Recent tentative signs of improvement in business activity may prove sufficient to persuade the MPC to take a pause in February, but there is still an argument for a further stimulus to try and cement the recovery. Either way, there appears little chance of interest rates increasing much before the end of 2010.

UNITED STATES: The US economy appears to be on the road to recovery. Activity in both the manufacturing and service sectors is picking up (albeit from extremely weak levels) and the pace of job losses moderated towards the end of the year. Assuming we do not get another bout of financial market turbulence, the key question for 2010 is when and at what pace the Federal Reserve will remove its various emergency stimulus measures used to support the financial sector and the economy through 2008/09.

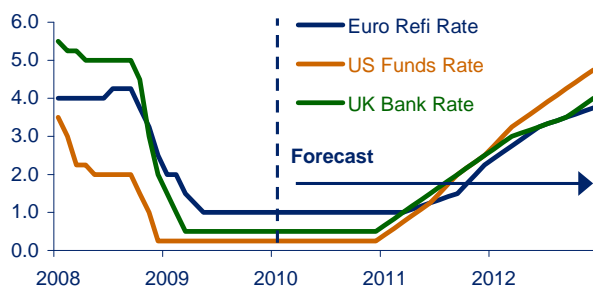
Policymakers have already indicated that most of the measures used to provide extra liquidity to the financial system - such as the purchase of mortgage-backed securities - will be wound down by the end of the first quarter of 2010. However, this still leaves a considerable degree of uncertainty over when the Fed will start to raise interest rates. Fed Chairman Ben Bernanke has indicated that he is in no rush. We think the weakness of the recovery will keep rates on hold for most, if not the whole, of this year, with the first rate rise coming in late 2010 or early 2011.

EURO AREA: The European Central Bank (ECB) is expected to leave interest rates unchanged at its meeting this month and at most of the meetings through the rest of this year. Money and credit growth continue to slow, pointing to low inflationary pressure over the medium term. M3 money growth, the ECB's preferred gauge of future inflation, turned negative in November for the first time since records began in January 1981, as household and business demand for credit fell. Overall price, cost and wage developments will likely remain subdued this year, in-line with demand in the euro area and elsewhere.

Although growth should be positive in 2010, the pace of recovery is expected to be tame. The PMI survey of business activity recorded an expansion in the three months to December, and consumer and business confidence is gradually returning. After six months of negative outturns, inflation returned to positive territory in November, rising to 0.9% y/y at the end of 2009. However, this is mostly due to base effects (low oil prices a year ago). Weak demand suggests inflation will continue to undershoot the ECB's 2% ceiling throughout the year.

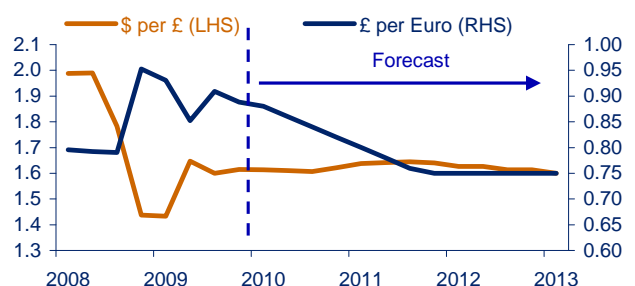
Interest Rate Forecast in %

Source: Thomson Datastream, RBS Group Economics



Exchange Rate Outlook

Source: Thomson Datastream, RBS Group Economics



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Exchange Rates

The last month saw a strong rebound in the dollar against all the major currencies. The world's premier reserve currency rose a solid 6c against sterling (from \$1.66 to \$1.59), and almost 10c against the Euro (\$1.508 to \$1.425). Against the Japanese yen there was also movement, with the yen moving solidly back into the 90's, having strengthened to Y86.7 at the start of December.

Good news from the US looks to have driven the ascent. Employment levels held steady in November - their best reading since the recession began in 2007. The number of people employed fell again in December, but the 85K monthly decline, was well below the declines seen earlier in the year. This was taken by investors as a sign of a turnaround in economic fortunes.

The pick up in US inflation is also likely to have brought forward the date at which investors expect the Fed to start normalising policy. US inflation jumped to 1.8% in November, having been negative for the previous twelve months.

Our medium-term outlook for exchange rates remains unchanged. The dollar is probably close to fair value against sterling as the UK and US economies face similar long term pressures. The euro looks a little strong against both the dollar and the pound, having benefited in recent months from concern over inflation and unsustainable debt/deficit levels elsewhere. We expect the euro to lose some ground in the medium term, eventually moving towards 0.75 against sterling and 1.20 against the dollar.

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 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	7 Jan, 4 Feb, 4 Mar, 8 April, 6 May, 10 June, 12 July
US Federal Reserve	27 Jan, 16 Mar, 28 June, 10 Aug, 21 Sept
European Central Bank	14 Jan, 4 Feb, 4 Mar, 8 Apr, 10 June, 8 July, 5 Aug

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