

# Interest & Exchange Rate Forecast

9<sup>th</sup> August 2010

## Interest Rates

**UNITED KINGDOM:** The Monetary Policy Committee (MPC) left interest rates at 0.5% and asset purchases on hold at £200bn in August. The minutes of the previous meeting noted the uncertainty around the outlook for economic growth and inflation, fuelling debate about the most appropriate course for interest rates. Recent data have further muddied the waters.

UK inflation has remained consistently above the 2% target and the increase in VAT from January will extend this trend into 2011. This inflation "stickiness" largely reflects a succession of one-off factors rather than excess demand in the economy, namely: higher global commodity prices, changes to indirect taxes and the depreciation of sterling (which increases the cost of imports). Nevertheless, policymakers are worried that such a persistent overshoot could lead to inflation becoming a structural problem if it starts to feed through to higher wage settlements. An early increase in rates could help to reduce that risk. The fact that the UK economy grew at a surprisingly robust 1.1% q/q in Q2, might also suggest that it is time to start thinking about returning interest rates to more "normal" levels.

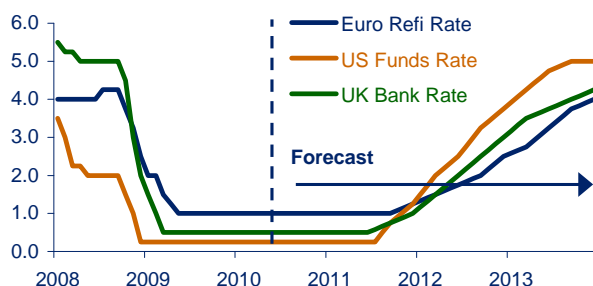
But in our view raising rates too soon remains the greater risk. Much of the growth recorded in Q2 looks to have been due to higher government spending, which is likely to fall significantly in the quarters ahead. Labour market conditions are weak, which will keep a lid on wage demands, and with firms still operating well below their full potential, this suggests business investment is also likely to remain anaemic. Nor can we look to exports to provide much of a boost, given signs that the global economic recovery is losing momentum. On balance we believe that policymakers will also conclude that pre-emptive rate rises would pose too great a risk to the recovery – which would be difficult to re-ignite with rates already close to zero and public finances stretched. Inflation pressures are likely to moderate eventually, given the amount of spare capacity in the economy – indeed, there is a danger that CPI will be too low once the VAT change falls out of the calculation. Although the outlook remains uncertain, we don't expect the first rise in the Bank rate until well into 2011.

**UNITED STATES:** The Federal Open Market Committee (FOMC) meets on 10<sup>th</sup> August. Rates are likely to remain on hold at 0%-0.25% and the Fed's statement will probably re-iterate that it intends to keep rates "extremely low" for an "extended period", but the FOMC may introduce a subtle shift in policy. The Fed appears to be considering re-investing the proceeds of the maturing mortgage bonds that it purchased as part of its asset purchase scheme to boost the economy. The funds would most likely be used to purchase Treasury securities, which would help keep down medium and longer-term interest rates which would provide a modest additional stimulus. It's not hard to see why further policy easing is being considered.

Recent data indicate that the recovery is losing momentum. Growth moderated from 3.7% q/q (annualized) in Q1 to 2.4% in Q2, with most analysts expecting this already disappointing out-turn to be revised down to below 2% in the weeks ahead. Employment growth has slowed sharply, with unemployment still at extremely high levels. Against this backdrop policymakers are increasingly concerned by the risk of deflation (falling prices). Core consumer price inflation, a good measure of underlying price pressures, remains close to all-time lows, and with growth so weak and plenty of slack in the economy, further declines are likely in the months ahead. The FOMC will be keen to avoid replicating Japan's experience, where deflation was symptomatic of, and in part a reason for, more than a decade of economic underperformance.

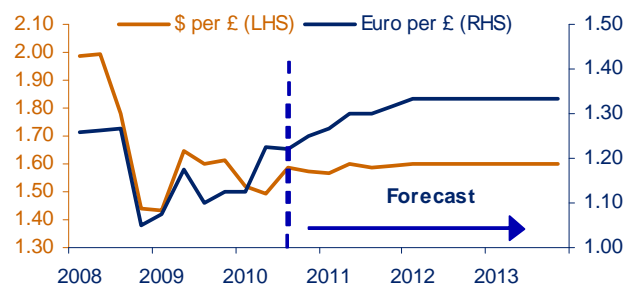
### Interest Rate Forecast in %

Source: Thomson Datastream, RBS Group Economics



### Exchange Rate Outlook

Source: Thomson Datastream, RBS Group Economics



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We expect the US recovery to gradually re-gain some momentum in the quarters ahead, but balance sheet repair in the household sector (which means weak spending and more saving) will probably continue to keep the pace of growth below that seen in previous recovery periods. Against this backdrop interest rate rises still appear a long way off – we don't expect the first rate hike until the latter half of 2011.

**EURO AREA:** The European Central Bank (ECB) kept interest rates on hold at 1.0% at its meeting last week. In a number of respects the economic climate is much the same in the Eurozone as it is in the UK and the US: growth is moderate and domestic price pressures are contained. Although the performance of the Eurozone economy was better than expected in Q2, households are hesitant to increase spending while unemployment remains high at 10%, and businesses continue to pare back their borrowing, keeping the pace of money growth in the single currency block flat. The speed of recovery remains uneven across countries, with many periphery economies vulnerable to any resurgence of concerns about public debt levels. Whilst inflation crept up to 1.7% in July, inflation expectations remain firmly anchored below the ECB's 2% target ceiling. With price pressures expected to stay subdued, we don't see interest rate moving before Q3 next year.

## Exchange Rates

The last month saw a substantial decline in the dollar against the major currencies. The world's premier currency slid 7c against the pound (from \$1.52 to \$1.59), and 5c against the euro (from \$1.27 to \$1.32). There were two main drivers. First, signs that US economy is losing momentum and that further stimulus may be needed dented sentiment towards US assets. Second, Europe's stress tests eased investors' worst fears and boosted confidence in the euro area banking system. The results showed that only 7 of 91 European banks fell short of capital requirements, sending bond yields lower and helping banks to issue new debt. In addition, business surveys painted a brighter picture for the continent's economy.

Our medium-term outlook for exchange rates remains unchanged. The dollar is probably close to the fair value against sterling as the UK and US economies face similar long-term pressures. We think the euro is likely to lose some ground in the medium term, eventually moving towards 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
<b>2010 Q1</b>	1.52	1.35	1.12	93	1.00	0.25	0.50
<b>Q2</b>	1.50	1.22	1.22	88	1.00	0.25	0.50
<b>Q3</b>	1.59	1.30	1.22	92	1.00	0.25	0.50
<b>Q4</b>	1.58	1.26	1.25	93	1.00	0.25	0.50
<b>2011 Q1</b>	1.57	1.24	1.27	93	1.00	0.25	0.50
<b>Q2</b>	1.60	1.23	1.30	93	1.00	0.25	0.50
<b>Q3</b>	1.58	1.22	1.30	94	1.00	0.75	0.75
<b>Q4</b>	1.59	1.21	1.32	95	1.25	1.25	1.00
<b>2012 Q1</b>	1.60	1.20	1.33	95	1.50	2.00	1.50
<b>Q2</b>	1.60	1.20	1.33	95	1.75	2.50	2.00
<b>Q3</b>	1.60	1.20	1.33	95	2.00	3.25	2.50
<b>Q4</b>	1.60	1.20	1.33	95	2.50	3.75	3.00

Key Central Bank Monetary Policy Meetings in 2010	
<b>Bank of England</b>	9 Sept, 7 Oct, 4 Nov, 9 Dec
<b>US Federal Reserve</b>	10 Aug, 21 Sept, 3 Nov, 14 Dec
<b>European Central Bank</b>	9 Sept, 7 Oct, 4 Nov, 2 Dec

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