

Interest & Exchange Rate Forecast

27th August 2009

Interest Rates

GLOBAL: The world's central bankers met in Jackson Hole, Wyoming, in mid-August for their annual get together. Officials indicated that talk of higher rates and QE "exit strategies" was premature. Central Bank governors intimated that rates could be maintained at ultra low levels for a considerable time without generating inflation - despite the more encouraging tone of recent data releases.

UNITED KINGDOM: There have been further signs that activity may be bottoming out. Purchasing Managers' Indices, good early indicators of economic growth, were more buoyant in July - the manufacturing index joined the services sector in expansion territory for the first time in 15 months. House prices have also edged up from their lows and may show a rise for the year as a whole. On the downside, unemployment continues to tick up, albeit quite slowly, and average earnings growth has been very weak.

But UK policymakers have yet to be convinced that we are firmly on the road to recovery. According to the minutes of the July Monetary Policy Committee meeting, without more money being pumped into the economy, inflation would be likely to undershoot the 2% target in the medium term, an implicit assessment that growth will be weak for quite some time. Consequently QE was expanded by another £50bn to £175bn, roughly 12% of GDP, and could be expanded further if considered necessary. Indeed, the Governor of the Bank of England favoured a rise to £200bn, but was out voted. This affirms our belief that interest rates will be on hold for a long time yet.

UNITED STATES: In his speech to the symposium in Jackson Hole, Fed Chairman Bernanke, was cautious not

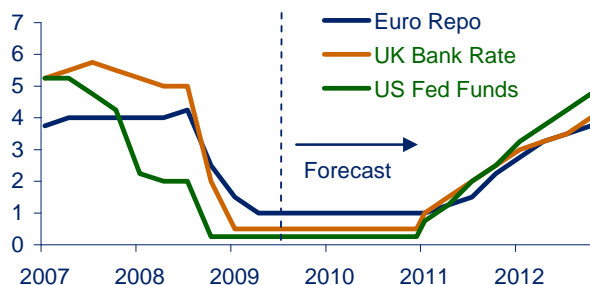
to over-egg the growth prospects for the US economy. Doing so could raise long-term interest rates and scupper any nascent recovery. But he accepted that things were levelling out, both in the US and abroad, and that prospects for a near-term return to growth looked good. He also noted that a recovery would start slowly and unemployment would take time to fall. This underscores the Fed's recent stance - to leave interest rates at near zero for an "extended period", and to lengthen the time over which it will undertake quantitative easing.

On balance, activity data have been encouraging. The first estimate of growth in Q2 showed the economy contracting by only 1% (annualised), much less than expected, and Q3 survey data have suggested that conditions continue to improve, especially in the manufacturing sector, which may already be growing. Even unemployment unexpectedly ticked down to 9.4% in July (though this may represent people leaving the labour market as jobs continue to be shed). Concerns over deflation (CPI was -2.0% in July) are being allayed by high core price inflation (which excludes volatile food and energy) at 1.5%.

EURO AREA: Activity in the euro area rebounded strongly in Q2 with Germany and France, which together make up over 50% of the euro economy, recording +0.3% Q/Q growth. For the region as a whole, Q2 didn't mark the end of the recession, as weaker performances from the smaller economies kept output growth in negative territory. The ECB remains cautious on the outlook, and whilst it appears set to revise up its growth forecasts in September, interest rates will remain on hold, and asset purchases continue to be used to keep financial markets liquid.

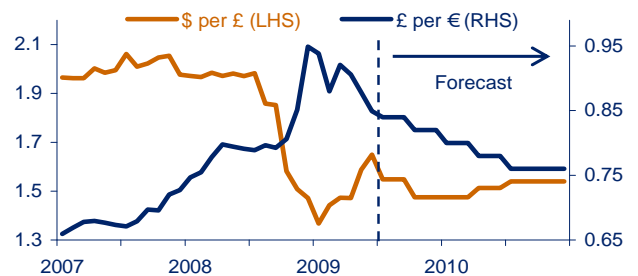
Interest Rate Forecast (%)

Source: Thomson Datastream, RBS Group Economics



Exchange Rate Outlook

Source: Thomson Datastream, RBS Group Economics



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Exchange Rates

Conflicting news created more than the normal degree of volatility across some exchange rates last month. At the start of August, the pound strengthened against the dollar, amid signs of a rebound in the manufacturing and service sectors and stabilisation in the housing market. But the run was short-lived. The extension of quantitative easing by the Bank of England, with its implication that rates could remain lower for longer, led sterling to give up its earlier gains. By the end of August the pound had fallen back to more or less where it was in early July.

Against the euro, the pound's downward trend was sustained through much of August. The surprise return to growth in Germany and France boosted demand for the single currency in spite of ECB President Trichet being among the central bankers at the Jackson Hole symposium supporting the notion of low rates for a long time. We continue to expect the pound to strengthen modestly against the euro over the medium term and to fall back slightly against the dollar, but risks abound as the economic outlook remains highly uncertain.

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
2008 Q1	1.98	1.56	0.79	102	4.00	2.25	5.00
Q2	1.99	1.58	0.79	106	4.00	2.00	5.00
Q3	1.77	1.40	0.79	106	4.25	2.00	4.50
Q4	1.44	1.39	0.95	91	2.50	0.25	2.00
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	1.64	1.39	0.85	95	1.00	0.25	0.50
Q4	1.62	1.36	0.84	95	1.00	0.25	0.50
2010 Q1	1.61	1.32	0.82	95	1.00	0.25	0.50
Q2	1.59	1.28	0.81	95	1.00	0.25	0.50
Q3	1.59	1.26	0.79	95	1.00	0.25	0.50
Q4	1.58	1.22	0.77	95	1.00	0.25	0.50

Key Central Bank Monetary Policy Meetings in 2009	
Bank of England	10 Sept, 8 Oct, 5 Nov, 10 Dec
US Federal Reserve	22 Sept, 4 Nov, 15 Dec
European Central Bank	3 Sept, 8 Oct, 5 Nov, 3 Dec

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