

# Interest and Exchange Rate Forecast

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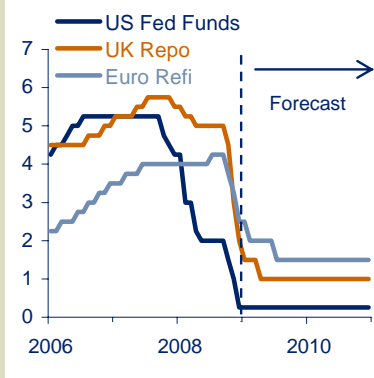
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## Interest Rate Forecast (in %)

Source: Thomson Datastream/RBS Group Economics



## Interest Rates

**The Monetary Policy Committee (MPC) delivered another large cut at its December meeting, lowering the Bank Rate by 100bps to 2%.** Official interest rates now stand at their lowest level since the early 1950s. The aggressive nature of the policy response is not difficult to justify, given how pervasive weakness has become. The unemployment rate hit 6% in October – a figure not seen since 1999. The latest Bank of England Regional Agents' survey noted that firms were limiting investments 'to essentials'. Trade has so far failed to offset the pronounced slump in domestic demand. In spite of sterling's 23% depreciation against a basket of major currencies over the last 14 months, most recent data suggest that the trade deficit has hardly improved. This shows how risky it is to rely on foreign demand to put a floor under domestic activity at a time when most parts of the world have plunged into recession as well. With the risks of a deep and protracted recession rising, we expect the MPC to cut rates to 1% next year. Unorthodox policy measures similar to those already in train in the US will probably follow.

**The Federal Reserve took policy rates to all-time lows in December, with its historic decision to target a Fed funds rate of 'between 0% and 0.25%'. The Fed has also made it clear that rates will stay low in the foreseeable future:** "Weak economic conditions are likely to warrant exceptionally low levels of the federal funds rate for some time." With conventional interest rate policy exhausted, the Fed is turning to more unconventional measures to support the economy – especially as the spectre of deflation looms. Going forward, the size and composition of the Fed's balance sheet will be the best gauge of how active the Fed is in increasing the money supply and in trying to affect borrowing costs directly. The planned purchases of commercially traded debt instruments (including longer-term Treasury bonds), for example, will boost the Fed's balance sheet. Last month, the Fed had already announced that it was going to spend up to \$600bn buying mortgage-backed securities and debt issued by Government Sponsored Enterprises (primarily Fannie Mae and Freddie Mac) in a bid to push down long-term mortgage rates. Essentially, all of the announced measures are non-standard attempts to reduce the cost of finance for companies and households and to increase the amount of liquidity in the financial system.

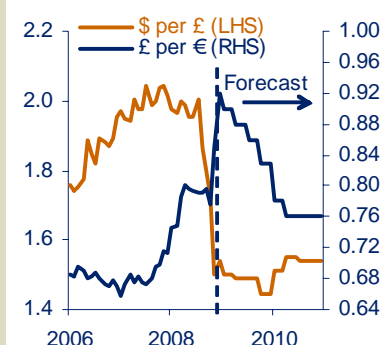
**The European Central Bank (ECB) cut interest rates by 75bps to 2.5% in December, the largest cut in its history.** The guardian of the single currency has been the least willing of the major central banks to 'look through' spikes in inflation. Only now that inflation is falling like a stone is the ECB willing to ease its policy stance. The official inflation reading came in only 0.1 percentage points above the official 2% ceiling in November, down from 3.2% previously. The Eurozone economy certainly needs all the support it can get. Industrial production, a good gauge of the health of overall economic conditions in the region, fell twice as quickly in October (5.3% y/y) as in September (2.4%). Unemployment rose to 7.7%, 0.5 percentage points above March's all-time lows. Reflecting these grim developments, the ECB now officially expects the overall economy to contract next year, and inflation to remain persistently below 2%. On this basis there should be nothing to prevent the Governing Council reducing rates further. We expect policy rates to be cut to 1.5% in 2009 with the next downward move in February.

*If interest rates are cut to zero, are policymakers out of ammunition?*

Click [here](#) to read our report

### Exchange Rate Outlook

Source: Thomson Datastream/RBS Group Economics



## Exchange Rates

**The pound failed to find respite in December**, plunging to £0.95 against the euro, a fresh all-time low. In part, the dive is a reflection of larger rate cuts in the UK. UK rates have fallen by 2.5 percentage points since November, compared with only 1.25 percentage points in the Eurozone. Ongoing sterling weakness also testifies to investors' concern about the downbeat tone of recent news on the state of the UK economy. But at these levels, sterling assets appear cheap by historic standards. Eventually, this should tempt foreign investors to move back into sterling, especially as the outlook for both the Eurozone and US is hardly rosy either. Both areas are expected to contract in 2009, with interest rates at generational lows for a prolonged period. Nevertheless, there is a risk that the pound's depreciation turns into a self-reinforcing rout, driven by investors' perception that staking money against sterling is a one-way bet. The outlook is extremely uncertain, but we expect the valuation perspective to prevail in the medium-term, with sterling strengthening against the single currency.

**The dollar rally was swiftly reversed in December, with the greenback retreating 6% against sterling and 11% against the euro in less than two weeks.** With the Fed officially committing to 'printing money' to fend off the dangers of deflation, foreign exchange markets are expressing concerns that these operations might undermine the long-term value of the dollar. This is understandable – printing money has proven to be one of the surest mechanisms to debase a currency in the past. But this time it could play out differently. The world economy has entered a downturn that has the potential to be one of the most severe in history. And it looks increasingly likely that many central banks will have to tread a policy path similar to the Fed sooner or later. When this happens, the greenback will regain ground.

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>2008 Q1</b>	1.99	1.46	0.73	112	4.00	4.25	5.25
<b>Q2</b>	1.98	1.56	0.79	102	4.00	2.25	5.00
<b>Q3</b>	1.99	1.58	0.79	106	4.00	2.00	5.00
<b>Q4</b>	1.55	1.44	0.93	90	2.50	1.00	2.00
<b>2009 Q1</b>	1.50	1.35	0.90	90	2.00	0.50	1.50
<b>Q2</b>	1.49	1.31	0.88	85	2.00	0.25	1.00
<b>Q3</b>	1.49	1.28	0.86	85	1.50	0.25	1.00
<b>Q4</b>	1.45	1.20	0.83	90	1.50	0.25	1.00
<b>2010 Q1</b>	1.51	1.18	0.78	92	1.50	0.25	1.00
<b>Q2</b>	1.55	1.18	0.76	95	1.50	0.25	1.00
<b>Q3</b>	1.54	1.17	0.76	95	1.50	0.25	1.00
<b>Q4</b>	1.54	1.17	0.76	95	1.50	0.25	1.00

### Key Central Bank Monetary Policy Meetings in 2009

<b>Bank of England</b>	8 Jan, 5 Feb, 5 Mar, 9 Apr, 7 May, 4 Jun, 9 Jul, 6 Aug, 10 Sep, 8 Oct, 5 Nov, 10 Dec
<b>US Federal Reserve</b>	28 Jan, 17 Mar, 29 Apr, 24 Jun, 11 Aug, 22 Sep, 4 Nov, 15 Dec
<b>European Central Bank</b>	15 Jan, 5 Feb, 5 Mar, 2 Apr, 7 May, 4 Jun, 2 Jul, 6 Aug, 3 Sep, 8 Oct, 5 Nov, 3 Dec

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