Group Economics

Interest and Exchange Rate Forecast

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Contacts:

Robert Gardner (**UK**)
Group Economics
+44 131 626 3697
robert.a.gardner@rbs.co.uk

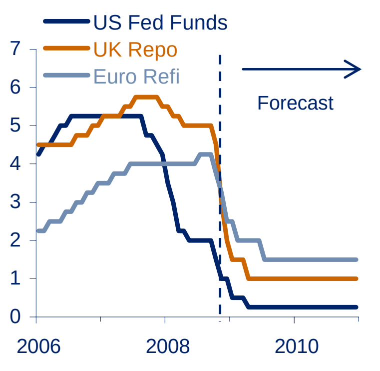
Robert Blotevogel (**UK/FX**)
Group Economics
+44 131 626 3953
robert.blotevogel@rbs.co.uk

Julien Seetharamdoo (**US**)
Group Economics
+44 131 626 3925
julien.seetharamdoo@rbs.co.uk

David Rea (**EZ**)
Group Economics
+44 131 626 3889
david.a.rea@rbs.co.uk

Interest Rate Forecast (in %)

Source: Thomson Datastream/RBS Group Economics



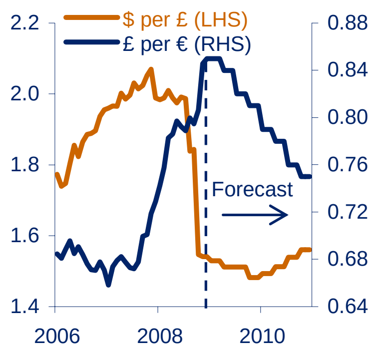
Interest Rates

The Monetary Policy Committee (MPC) took everyone by surprise, lowering the Bank Rate by an unprecedented 150bps to 3% in November. The rationale became clear in the Bank of England's Quarterly Inflation Report. It revealed the Bank's expectation that the economy will contract by 1.3% in 2009, which is towards the pessimistic end of forecasts. With global commodity prices falling sharply and demand forecast to be so weak, inflation is expected to fall sharply. Indeed, the Bank estimates a 20% chance of inflation turning into deflation (a falling price level) in the next twelve months. Central bankers will want to avoid a period of sustained deflation at all costs, not least because it is a difficult situation to reverse. Moreover, in times of falling prices, consumers shy away from big-ticket purchases (because a better deal could be had in future), depressing spending. More importantly, deflation increases the real cost of debt, putting even more pressure on borrowers. Further aggressive Base Rate cuts are therefore highly likely. We think the MPC will lower rates by as much as 100bps in December, before taking rates down by a further half a percentage in Q1 2009. The reduction may be more gradual, but either way rates look set to be cut to all-time lows in the coming months.

With no scheduled meeting in November, the Fed left rates unchanged at 1%. In spite of the aggressive easing so far, the US economy contracted by 0.1% in the third quarter. Consumer spending declined for the first time in real terms since 1991, as tighter credit conditions, plummeting home and equity prices, and a deteriorating labour market took their toll. Employment has fallen by 520,000 in September and October alone. Concerns about inflation are also being rapidly replaced by concerns about deflation. Indeed, consumer prices in the US recorded their largest ever month-on-month fall in October – declining oil prices pulled energy and fuel costs down by over 8%. But the moderation was not purely the result of energy price trends. Core CPI (which excludes food and energy) declined for the first time since 1982. As a result, we expect the Fed to cut interest rates by another 50bps when it meets for its two-day rate setting meeting on 15/16 December, taking the fed funds target rate to just 0.5%. Going forward, with rates so low, the Fed is likely to focus its efforts increasingly on expanding the money supply in order to stave off the threat of deflation.

The European Central Bank (ECB) joined the Bank of England in trimming rates, but with a more modest 50bps reduction to 3.25%. It's telling of the slightly more restrained approach on the continent that November was the first month since the inception of the single currency where official rates in the Eurozone were higher than in the US and the UK. But the economic situation does not look much brighter. The Eurozone already entered recession officially in Q3. Germany, the region's largest economy, led the way with a -0.5 q/q decline in activity. Spain fared only slightly better with a -0.2% q/q contraction. France and Italy managed to eke out positive growth figures. However, surprises of the positive variety are unlikely to be repeated. The flash PMIs, leading indicators of activity in the manufacturing and service sectors, deteriorated further in November and suggested that weakness was becoming more widespread. With both survey and financial market-based inflation expectations coming down sharply in recent weeks, the case for more rate cuts looks compelling – we expect a 75bps reduction at ECB's December meeting.

Exchange Rate Outlook
Source: Thomson Datastream/RBS Group Economics



Exchange Rates

Negative investor sentiment continues to act as a drag on sterling. The pound failed to recover from the multi-year lows against the currencies of the UK's main trading partners in November, remaining almost unchanged at $1.54 and £0.85 against the dollar and the euro, respectively. Sterling's weakness reflects investor's concerns over robustness of the overall UK economy. For one, the UK private sector is highly indebted, both historically and by international standards, making it more vulnerable to the tougher credit environment. The financial sector is also structurally more important than in other economies, with the sector accounting for half of the 1.6mn new jobs created since 2002 – even though financial services only represent c.7% of the whole economy. Until the outlook becomes clearer, sterling is poised to stay weak.

The US economy is also heading into a serious downturn, but the dollar appears to be benefiting from its reserve currency status. In times of unprecedented risk aversion, investors long for currencies that serve as a store of value. And of all currencies, the dollar seems to fit be bill most closely. Due to an increasingly uncertain global outlook, investors continue to sell assets held in many emerging markets, parking the proceeds in dollars. This process lends significant support to the greenback. The euro, on the other hand, does not appear to have benefited to the same extent from such safe haven flows. This suggests that the single currency has yet to displace the dollar as the world's leading reserve currency.

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	1.99	1.58	0.80	100	4.00	4.25	5.25
Q2	1.99	1.58	0.79	106	4.00	2.25	5.00
Q3	1.78	1.40	0.79	106	4.00	2.00	5.00
Q4	1.54	1.31	0.85	100	2.50	0.50	2.00
2009 Q1	1.53	1.30	0.85	98	2.00	0.25	1.50
Q2	1.51	1.27	0.84	95	2.00	0.25	1.00
Q3	1.51	1.24	0.82	93	1.50	0.25	1.00
Q4	1.48	1.20	0.81	92	1.50	0.25	1.00
2010 Q1	1.49	1.18	0.79	90	1.50	0.25	1.00
Q2	1.51	1.18	0.78	90	1.50	0.25	1.00
Q3	1.54	1.17	0.76	90	1.50	0.25	1.00
Q4	1.56	1.17	0.75	90	1.50	0.25	1.00

Key Central Bank Monetary Policy Meetings in 2008/2009

Bank of England	4 Dec, 8 Jan, 5 Feb, 5 Mar, 9 Apr, 7 May, 4 Jun, 9 Jul, 6 Aug, 10 Sep, 8 Oct, 5 Nov, 10 Dec
US Federal Reserve	16 Dec, 28 Jan, 17 Mar, 29 Apr, 24 Jun, 11 Aug, 22 Sep, 4 Nov, 15 Dec
European Central Bank	4 Dec, 15 Jan, 5 Feb, 5 Mar, 2 Apr, 7 May, 4 Jun, 2 Jul, 6 Aug, 3 Sep, 8 Oct, 5 Nov, 3 Dec