

Interest & Exchange Rate Forecast

5th March 2010

Interest Rates

UNITED KINGDOM: The MPC left interest rates unchanged at 0.5% and maintained the stock of assets purchased at £200bn this month. The governor, Mervyn King, has continued to emphasise the fragility of the current recovery, stating that the risks to the committee's view of gradual recovery remain to the downside. February's Inflation Report formalised these concerns, further lowering the inflation profile for the UK so that it undershoots the 2% target at the two-year policy horizon. The jump in the level of consumer prices to 3.5% in January (from 2.9% in December) reflected the reversion of VAT to its standard 17.5% rate and a rise in oil prices compared to a year earlier, not underlying price pressures.

Revisions to economic growth in Q4 were never likely to contradict this story of nascent recovery. The economy did expand by more than previously estimated (0.3% Q/Q rather than 0.1%), but from a lower starting point. The total output loss during the recession was revised up to 6.25% from 6%. The largest contributor to growth was a change in the level of stocks, though both government and consumer spending provided some support. Trade failed to provide a boost as import growth outpaced that of exports.

The path of interest rates depends on the recovery taking hold. As yet there is only evidence of fragility. A stalled recovery in the euro area, the UK's main trading partner, weighs on prospects for export growth, while significant spare capacity reduces the need and incentive for investment. We expect rates to be on hold until early 2011.

UNITED STATES: The Federal Open Markets Committee meets on the 16th March and is not expected to make any changes to the current targeted Federal Funds rate of 0% to 0.25%. However, with dissent from Kansas City Fed President Hoenig at January's meeting, there could be important changes in the statement. Mr Hoenig was

concerned that the current statement that rates would be "exceptionally low, for an extended period", did not offer policy flexibility. With economic and financial conditions improving, rates might have to be raised more quickly than the Fed (or we) currently anticipate.

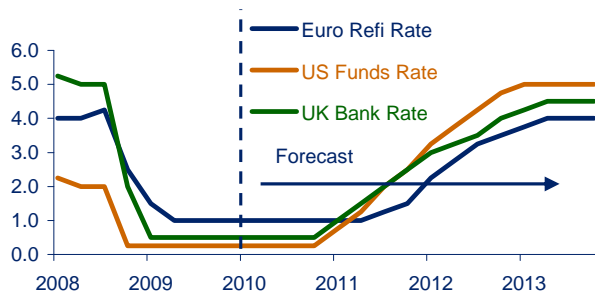
The US economy expanded at a faster pace in Q4 than first thought. Growth at an annualised rate of 5.9% (revised up from an initial 5.7%) would suggest a recovery is well underway. But like the UK, much of this came from a change in the level of inventories. The outlook for final demand is very uncertain, complicating the interest rate decision. Consumers are repairing their balance sheets at the same time that support from exceptional fiscal programs unwinds, although a weak dollar has supporting demand for exports. We maintain our view that the Fed Funds rate will remain on hold till year end, but the risk of an earlier increase is rising.

EURO AREA: The European Central Bank left interest rates unchanged in February. We expect rates to remain at current lows into 2011 as the recovery has tailed off and price pressures are insignificant.

The euro area is like a microcosm of the global rebalancing story. Germany needs to boost domestic demand; the peripheral economies (like Portugal, Spain and Greece) need to rein it in and grow through exports. Sharing one currency makes this harder. The periphery lost competitiveness due to rising unit labour costs during the boom years. The bitter pill of falling nominal wages or higher productivity growth is needed to restore the balance. Recent pay restraint in Germany makes this hard to achieve. As fiscal supports diminish, and with a still strong euro, loose monetary policy is the only guardian against even weaker demand and the prospect of a return of deflation.

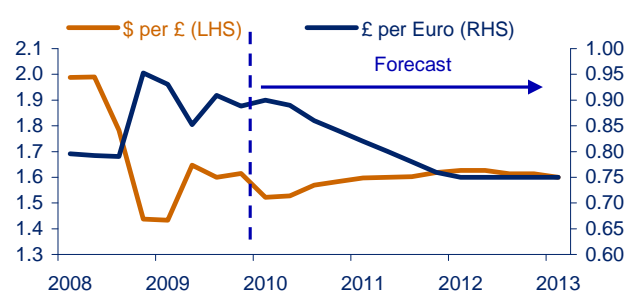
Interest Rate Forecast in %

Source: Thomson Datastream, RBS Group Economics



Exchange Rate Outlook

Source: Thomson Datastream, RBS Group Economics



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Exchange Rates

There was more than the usual degree of volatility across some exchange rates last month, as the dollar rebounded strongly against all the major currencies and sterling came under pressure. The pound fell to a ten-month low against the dollar (\$1.49) and slipped 4c against the euro to €0.90.

Sterling's move lower appeared to reflect investors' growing concerns over the UK government's ability to fix its finances after the upcoming general election. Recent polls suggested the possibility of a hung parliament. This adds to the uncertainty surrounding the timing and implementation of a feasible government plan to rein in the deficit and reduce the ballooning debt level.

But it doesn't rain, it pours. Investors also shunned the pound after the Bank of England Governor refused to rule out a further extension to the Bank's asset purchase program (aka QE) over worries about the UK recovery.

In our view, the medium term outlook for the three economies has changed little. Rebalancing to a more sustainable growth path and reducing debt remain the priorities for the US and UK. In the short term, further volatility is likely given the uncertain outlook. However, over the medium to longer term we expect the pound to recover ground lost to the dollar, settling back at around 1.60, and appreciate towards 0.75 against the euro.

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	1.52	1.37	0.90	93	1.00	0.25	0.50
Q2	1.53	1.36	0.89	94	1.00	0.25	0.50
Q3	1.57	1.35	0.86	95	1.00	0.25	0.50
Q4	1.58	1.33	0.84	95	1.00	0.25	0.50
2011 Q1	1.60	1.31	0.82	95	1.00	0.75	1.00
Q2	1.60	1.28	0.80	95	1.00	1.25	1.50
Q3	1.60	1.25	0.78	95	1.25	2.00	2.00
Q4	1.62	1.23	0.76	95	1.50	2.50	2.50
2012 Q1	1.63	1.22	0.75	95	2.25	3.25	3.00
Q2	1.63	1.22	0.75	95	2.75	3.75	3.25
Q3	1.61	1.21	0.75	95	3.25	4.25	3.50
Q4	1.61	1.21	0.75	95	3.50	4.75	4.00

Key Central Bank Monetary Policy Meetings in 2010	
Bank of England	4 Mar, 8 Apr, 6 May, 10 June, 8 July, 5 Aug, 9 Sept, 7 Oct
US Federal Reserve	16 Mar, 28 Apr, 23 June, 10 Aug, 21 Sept, 3 Nov, 14 Dec
European Central Bank	4 Mar, 8 Apr, 6 May, 10 June, 8 July, 5 Aug, 9 Sept, 7 Oct

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