

Interest and Exchange Rate Forecast

26th March 2009

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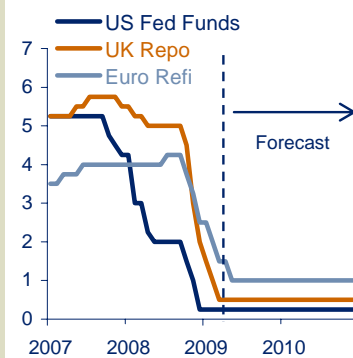
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Interest Rate Forecast (in %)

Source: Thomson Datastream/RBS Group Economics



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[Global Economic Outlook](#)

Interest Rates

The UK's Monetary Policy Committee (MPC) cut the Bank Rate by another 50bps to 0.5% at its March meeting. But the Committee made it clear that rate cuts alone would be insufficient to get the economy back on track. As a result, the MPC also announced that it was pressing ahead with 'quantitative easing' – the umbrella term for measures aimed at boosting the supply of money in the economy. The Bank of England is to spend £75bn (5% of GDP) of newly created money in the months ahead to buy UK government bonds (gilts) and private sector assets like corporate bonds. Purchases on such a large scale should help to support the price of these assets (pushing down their yield), thereby lowering borrowing costs for longer-term borrowing. Initial market reaction was more positive than many expected. Ten-year gilt yields fell below 3% within a week of the announcement, down from 3.6% before. But yields re-traced half the move in the weeks that followed, as investor concerns about the trajectory of public finances surfaced. If such worries persist, the Bank of England may have to step up its gilt purchases to ensure long-term rates stay low. We have entered uncharted territory and it will be several months yet before we know if the measures are gaining traction and supporting spending in the economy.

The Federal Reserve and the US Treasury are bringing in additional heavy artillery to battle the downturn. Despite tentative signs of stabilisation in retail sales in the opening months of 2009, overall, the data flow has remained downbeat. The unemployment rate sailed past the early 1990s high of 7.8% in February, to a 25-year high of 8.1%, pointing to further pressure on consumer spending in the months ahead. Industrial production continued to slide in February, with survey data suggesting further weakness in March. In response, the Fed unexpectedly announced that it would beef up its quantitative easing program by buying long-term US government debt. Even more importantly, it increased its planned purchase of agency mortgage-backed securities to \$1.25 trillion (about 30% of the market) to further lower mortgage rates. Meanwhile, the Treasury fleshed out details of how it intends to remove toxic assets from banks' balance sheets using a combination of public and private money. The proposals received resounding approval from equity markets, which rose sharply, suggesting that the scheme could be successful in helping the banking system to start lending again. The slew of recently announced policy support should help to stabilise the economy in the quarters ahead.

The European Central Bank (ECB) lowered interest rates by 50bps to 1.5% in early March. Calls for a cut had intensified in recent months, following a string of shockingly weak data suggesting that the region performed just as poorly in Q1 as in the previous quarter. Industrial production recorded its sharpest monthly fall on record in January, taking production back to the level prevailing five years ago. Unemployment continued its ascent, to 8.2%, in January. Forward looking indicators suggest that companies' capital spending plans are going to be as weak, if not weaker, in Q1 – no mean feat, given that investment declined by a massive 2.7% q/q in the final three months of 2008. The region's overall inflation rate has stabilised at 1.2% y/y, but the risks of deflation are rising, especially in some of the worst performing countries – Irish inflation fell to just 0.1% in February. If the ECB's view that, "risks to the economic outlook now appear to be more balanced", is anything to go by, it does not seem minded to cut rates again just yet. But pressure is

growing. We think that rates will be lowered further in the months ahead and that the ECB will eventually move towards a 'quantitative easing' programme.

Exchange Rates

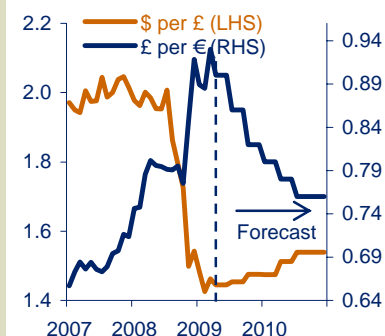
The performance of sterling and the dollar showed that investors remain concerned about the implications of 'printing money'. The currencies remained stable against each other, but lost about 6% against the euro over the past month. The most obvious explanation is that the central banks in the US and the UK have started quantitative easing. Investors appear to regard these moves as a potential threat to the long-term value of sterling and dollar assets. Most recent data on the US financial account also point to lack of enthusiasm for US assets abroad – foreigners sold \$19bn (net) of US long-term securities, mainly US government bonds, in January.

But the euro's status as a safe haven currency is unlikely to last long. The economic outlook for the euro area is equally dark as in the UK and the US. Some countries (Ireland and Spain) have seen large credit and housing booms, while the more export-oriented economies (like Germany and the Netherlands) are suffering from the slump in global trade. The euro area's strong ties with its neighbours to the east is an additional concern, with Central and Eastern Europe particularly exposed to the fallout of the global financial crisis.

The European Central Bank's current ultra-cautious approach may mean that the 'guardian of the single currency' will have to act even more vigorously at a later stage. This scenario looks increasingly plausible, not least because the extent of government support announced so far looks relatively modest. If investors do reassess the economic case for holding euro assets, the single currency will start to lose altitude.

Exchange Rate Outlook

Source: Thomson Datastream/RBS Group Economics



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	1.46	1.36	0.93	94	1.50	0.25	0.50
Q2	1.44	1.30	0.90	90	1.00	0.25	0.50
Q3	1.45	1.25	0.86	90	1.00	0.25	0.50
Q4	1.48	1.21	0.82	90	1.00	0.25	0.50
2010 Q1	1.48	1.18	0.80	92	1.00	0.25	0.50
Q2	1.51	1.18	0.78	95	1.00	0.25	0.50
Q3	1.54	1.17	0.76	95	1.00	0.25	0.50
Q4	1.54	1.17	0.76	95	1.00	0.25	0.50

Key Central Bank Monetary Policy Meetings in 2009

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

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