

# 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](mailto:robert.a.gardner@rbs.co.uk)

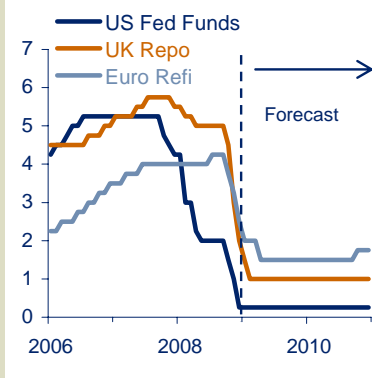
Robert Blotevogel (UK/FX)  
 Group Economics  
 +44 131 626 3953  
[robert.blotevogel@rbs.co.uk](mailto:robert.blotevogel@rbs.co.uk)

Gareth Claase (US)  
 Group Economics  
 +44 131 626 3873  
[gareth.claase@rbs.co.uk](mailto:gareth.claase@rbs.co.uk)

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

## Interest Rate Forecast (in %)

Source: Thomson Datastream/RBS Group Economics



## Interest Rates

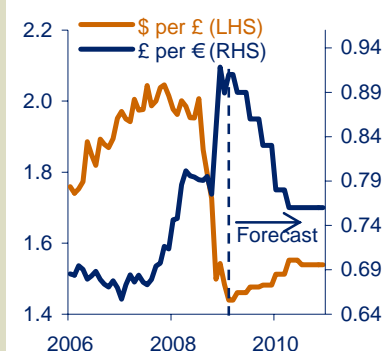
**The UK's Monetary Policy Committee (MPC) lowered the Bank Rate by another 50bps to 1.5% at its January meeting, as expected.** It is official, the UK is in recession. Economic activity declined for the second quarter running in Q4 2008, by a worryingly large 1.5% q/q. And it's becoming clearer by the day that the fallout from this financial crisis will be worse than the early 1990s recession. The anaemic state of domestic demand, together with the VAT cut, encouraged retailers to mark down prices to entice shoppers to spend before Christmas. This helped to drive inflation down by a full percentage point to 3.1% in December. With inflationary pressures easing, the Bank of England is resorting to non-traditional measures to fight the recession. The Bank has already announced that it will purchase £50bn of high quality assets to support the corporate sector's access to funding. We expect one more 50bps cut next month, although policy is likely to increasingly focus on intervention in credit markets to spur activity.

**With no scope to cut US short-term interest rates any further, not much is likely to happen at the January Federal Open Market Committee (FOMC) meeting.** The official statement will probably stick with the downbeat tone of recent months. Details of more 'credit easing' measures are unlikely to be announced until February, since the Federal Reserve Board needs to co-ordinate with the new administration's Treasury. For the time being, the Fed is continuing to purchase debt issued by Government Sponsored Enterprises (primarily Fannie Mae and Freddie Mac), and other mortgage-backed securities to bring down long-term mortgage rates. As a result, 30-year mortgage rates fell below 5% in January (down from 6.5% in October). Another policy focus is to clear banks' balance sheets of illiquid and hard to value assets – either in the form of a 'bad bank' which buys 'toxic' assets or as an asset guarantee scheme. The US Treasury is likely to be integral to any of these programs, so the beginning of their implementation will not necessarily coincide with future FOMC meetings.

**The European Central Bank (ECB) cut interest rates for the fourth month on the trot in January, lowering the main policy rate by 50bps to 2.0%.** Recent data were so downbeat that postponing a cut was no longer a viable option. Flagging global demand led to Eurozone exports tumbling by 4.7% y/y in November, the fastest pace in eight years – a particularly painful blow to export-oriented Germany. Industrial output is already falling at a breakneck pace and further declines look likely, given the 26% y/y fall in the value of new orders recorded for manufacturing firms in November. Domestic spending is under pressure too, as households pull back in response to a deteriorating labour market. Unemployment in the region is already at a two-year high. National governments have vowed to fight the downturn with all means possible. But investors' willingness to finance soaring public deficits appears more restrained, as evidenced by the rise in government bond yields of many countries and tepid demand at government debt auctions. The only silver lining is that inflation is moderating, equalling the all-time low of 1.6% y/y in December. With further declines in economic activity and inflation expected, it is hard to see how the ECB can refrain from lowering rates further. We expect rates to be cut by 50bps in Q2, if not before.

### Exchange Rate Outlook

Source: Thomson Datastream/RBS Group Economics



## Exchange Rates

**The past four weeks were again difficult for sterling.** The general consensus is that much of the bad news about the UK – its high current account deficit, its high dependency on financial services and its high indebtedness – are already reflected in sterling's depressed level against other major currencies. However, the announcement of the most recent government support package for the British banking system triggered new weakness in the middle of January. While the UK has just started what is a painful phase of structural adjustments, its key trading partners are in a similarly difficult economic position. This means that negative surprises and shifting investor sentiment are likely to become a drag on the Euro. The pound is also likely to make up some ground against the dollar, with investors becoming more mindful of a US Central Bank on the cusp of running the printing press.

**On a trade-weighted basis, the euro is virtually unchanged over the past twelve months.** It has lost 12% against the dollar, but gained 26% vis-à-vis the pound. To an extent, this reflected the belief that the Eurozone would be less affected by the financial crisis. These hopes have been dashed – even Germany, a country without a credit boom or a property bubble, faces a prolonged period of economic contraction. What is more, while the region is unified under a single interest rate policy set by the ECB, there is no direct mechanism to co-ordinate government expenditure across member states. Obviously, currency moves are impossible for individual member countries. We think that investors will soon start to acknowledge the Eurozone's limited flexibility in dealing with the deteriorating economic outlook more fully, which will quickly translate into a weakening euro in foreign exchange markets.

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>	1.98	1.56	0.79	102	4.00	2.25	5.00
<b>Q2</b>	1.99	1.58	0.79	106	4.00	2.00	5.00
<b>Q3</b>	1.77	1.40	0.79	106	4.25	2.00	4.50
<b>Q4</b>	1.44	1.39	0.95	91	2.50	0.25	2.00
<b>2009 Q1</b>	1.44	1.31	0.91	90	2.00	0.25	1.00
<b>Q2</b>	1.46	1.30	0.89	85	1.50	0.25	1.00
<b>Q3</b>	1.48	1.27	0.86	85	1.50	0.25	1.00
<b>Q4</b>	1.48	1.23	0.83	90	1.50	0.25	1.00
<b>2010 Q1</b>	1.51	1.18	0.78	95	1.50	0.25	1.00
<b>Q2</b>	1.55	1.18	0.76	100	1.50	0.25	1.00
<b>Q3</b>	1.54	1.17	0.76	100	1.50	0.25	1.00
<b>Q4</b>	1.54	1.17	0.76	105	1.75	0.25	1.00

### Key Central Bank Monetary Policy Meetings in 2009

<b>Bank of England</b>	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>	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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