Economic and monetary environment

The Group's earnings are affected by the economic and monetary environment in its key markets (UK, US, Eurozone and Asia Pacific).

Global financial markets entered a period of unprecedented strain in the second half of 2007, with reference interbank lending rates spiking sharply and parts of the short-term money market seizing up. This temporarily tightened monetary conditions, affecting credit supply and denting investor risk appetite, at a time when a slowdown in global economic activity had started. After a series of individual efforts, central banks in Canada, the Eurozone, Switzerland, the UK and the US intervened in concert to improve liquidity conditions in money markets in December. This measure was successful in bringing interest rate spreads in interbank markets back towards historic averages, but uncertainties about the full impact on the real economy and the future evolution of debt markets remain.

The UK interest rate cycle peaked in 2007, with the Monetary Policy Committee (MPC) first hiking the Bank Rate from 5% to 5.75% in three successive 25bps moves in January, May and July, before cutting it back to 5.50% in December and most recently to 5.25% in February. The rate increases were due to a combination of above-trend growth at 3.1% and CPI-inflation exceeding the official target of 2% for most of the year on the back of high commodity prices. Upside risks to inflation over the medium-term prevailed, preventing the MPC from cutting more aggressively in response to the liquidity squeeze in financial markets in December. On balance, monetary conditions were probably in restrictive territory in 2007, which is expected to lead to slower growth in 2008. Sterling's 6% depreciation on a trade-weighted basis only partly offset the dampening impact from strains in money markets and high inflation-adjusted interest rates, which only started to fall towards the end of the year.

US monetary conditions were close to neutral at the start of 2007, with policy rates on hold at 5.25% until the onset of the liquidity crisis in August. A marked slowdown in the US housing market, deterioration in consumer and business confidence and the liquidity squeeze in financial markets prompted the Federal Open Market Committee (FOMC) to bring the federal funds rate down to 4.25% by the end of the year. Despite a 10% decline in the value of the dollar on a trade-weighted basis and the resulting stimulus for US exports, the overall outlook for the US economy darkened materially in the first two months of 2008. The FOMC continued to react aggressively in the face of more evidence of downside risks to economic growth, and further reduced the policy rate by 125bps at two meetings in January, bringing it to 3.00% at the end of February 2008. Even though CPI-inflation ran above 4% by the end of 2007, US bond markets did not seem overly concerned about rising inflationary pressure in the longer term, as the long-end of the yield curve shifted downwards too.

Against the backdrop of robust demand, and an upward trend in CPI-inflation, the European Central Bank raised the official refinancing rate twice in the first half of 2007, from 3.5% to 4%, and staying on hold for the rest of the year. Rapid economic growth in emerging market economies resulted in strong demand for Eurozone export goods, despite a 5% trade-weighted appreciation of the euro. Overall, the Eurozone appeared to be less affected by the liquidity squeeze than the UK or the US, partly because domestic demand had been less reliant on credit.

Asia Pacific was the most dynamic region in 2007, with economic growth outpacing the rate of expansion recorded in other regions. Exports remained the main driver of economic growth, resulting in a large current account surplus, and corresponding inflows of foreign exchange into the region. Some countries in the region continued to manage their currencies, to prevent appreciation. This loosening of monetary conditions boosted domestic investment. Inflationary pressures started to emerge, possibly requiring a tighter stance of monetary policy further out.

In addition to influencing the level of effective demand countries face, exchange rates affect earnings reported by the Group's non-UK subsidiaries, and the value of non-sterling denominated assets and liabilities. Sterling remained strong against the dollar in 2007, gaining another 1%, but slipped by 8% against the euro. These movements have mixed effects on the Group's reported earnings, assets and liabilities, boosting their sterling-value when denominated in euro but depressing their sterling-value when denominated in dollars.

Supervision and regulation

1. United Kingdom

1.1 Authorised firms in the Group

The UK Financial Services Authority (FSA) is the consolidated supervisor of the Group and the Royal Bank. As at 31 December 2007, 31 companies in the Group (excluding subsidiaries of the ABN AMRO Group), spanning a range of financial services sectors (banking, insurance and investment business), were authorised to conduct financial activities regulated by the FSA.

The UK authorised banks in the Group include the Royal Bank, NatWest, Coutts & Co and Ulster Bank Ltd. Wholesale activities, other than Group Treasury activities, are concentrated in the Group's Corporate Markets division and are undertaken under the names of the Royal Bank and NatWest. UK retail banking activities are managed by the Retail Markets division. The exception is Ulster Bank Ltd, which is run as a separate division within the Group. Ulster Bank Ltd provides banking services in Northern Ireland while the banking service to the Republic of Ireland is provided by Ulster Bank Ireland Ltd which is primarily supervised by the Irish Financial Services Regulatory Authority.