

Interest and Exchange Rate Forecast

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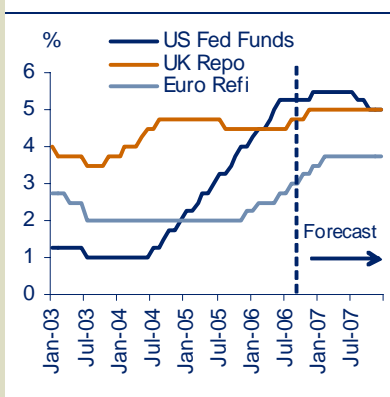
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Interest Rate Forecast

Source: Thomson Datastream/RBS Group Economics



Interest Rates

Policymakers in the key regions kept interest rates on hold in September, but further hikes are to be expected in the months ahead.

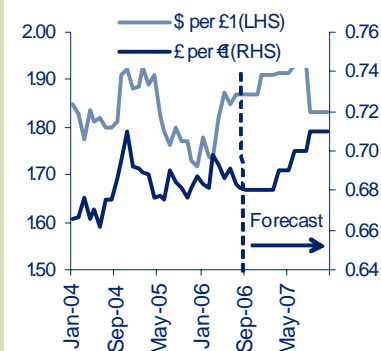
To hike, or not to hike, that is the question facing the UK's Monetary Policy Committee (MPC). The answer will depend on how it balances the challenging near-term inflation outlook and the prospect of slowing economic activity. CPI inflation will probably rise close to 3% by the end of the year, driven to a large extent by higher tuition fees. Lower petrol prices provide a powerful counter-weight, however, as do the downward revision to GDP data for Q2 and the recent moderation in leading indicators for Q3. On balance, another quarter-point rate hike seems more likely than not, probably in November, though it will be a close call. The decision to raise rates in August was heavily influenced by 'last-minute' data, which could easily happen again given the finely-balanced nature of the debate. (Keep an eye on our Chief Economist's [Weekly Brief](#) for analysis of the data as they emerge.)

Expectations for US interest rates have shifted decisively in recent weeks, amid fears that consumer spending will slow sharply on the back of a rapidly slowing housing market. Investors are now convinced that the next move in rates will be down, pricing in a rate cut (to 5%) as early as Q1 next year with rates then falling to around 4.5% by the end of 2007. In our view this is not the most likely outcome. Expectations of sluggish growth in the latter half of this year appear misplaced. Falling gasoline prices, if maintained, will provide significant support to household purchasing power and this, together with firming income trends, should more than offset the drag from the cooling housing market. Moreover, underlying inflation remains stubbornly above the Fed's comfort zone, suggesting that near-term rate cuts are unlikely. Indeed, a further rate hike, to 5.5%, will probably be required before the end of the year to ensure that growth remains close to its trend rate of around 3% and that underlying inflation moderates over the medium term. Even if another hike is not needed, interest rates are likely to maintain their current level for several quarters to come, rather than be reduced early next year, as investors expect.

We expect the European Central Bank (ECB) to raise interest rates by a quarter-point at its October and December meetings, taking rates to 3.5% by the end of the year. The ECB has made it clear that as long as the recovery is maintained, it will continue with its 'progressive withdrawal of monetary accommodation' in order to bring interest rates towards a more neutral range, where they are no longer stimulating economic activity and credit growth. Indeed, there is a good chance that the ECB will continue its monetary tightening into 2007. The latest data show that money supply growth accelerated unexpectedly in August, to 8.2% y/y, from 7.8% y/y in July, well-above the level the ECB sees as consistent with price stability. We expect at least one more rate increase early in 2007, bringing Eurozone interest rates to 3.75%.

Exchange Rate Outlook

Source: Thomson Datastream/RBS Group Economics



Exchange Rates

Sterling has remained at fairly elevated levels against the other major currencies over the past month. Private investors have been attracted to UK assets by the prospect of higher interest rates. Demand for the pound also appears to have been supported by central banks seeking to diversify their reserve holdings away from dollars. (In this context sterling is attractive as short term interest rates are still fairly high by international standards.) But, since we only expect one more rate rise in the UK, while rates continue to head higher in the Eurozone, sterling is likely to slip against the euro in the period ahead. The fact that the UK continues to run a large trade deficit with the Eurozone will contribute to the downward pressure.

The burgeoning US trade deficit is likely to become the focus of attention in the quarters ahead since US interest rates are near their peak, putting downward pressure on the greenback. This trend is likely to be reinforced by the fact that interest rates are expected to head higher in the Eurozone and in Japan over the period ahead, further reducing the relative attractiveness of the dollar for international investors. However, there is a risk that the dollar could make up some ground in the near term, including against sterling, if US rates stay higher for longer than investors currently expect.

RBS GROUP ECONOMICS INTEREST AND EXCHANGE RATE FORECASTS							
	EXCHANGE RATES (End-of-Period)				INTEREST RATES (%, End-of-Period)		
	\$ per £	\$ per EUR	£ per EUR	\$/JPY	Euro Refi Rate	US Funds Rate	UK Repo Rate
2005 Q1	1.89	1.30	0.69	107	2.00	2.75	4.75
Q2	1.79	1.21	0.68	111	2.00	3.25	4.75
Q3	1.77	1.21	0.68	113	2.00	3.75	4.50
Q4	1.72	1.18	0.69	118	2.25	4.25	4.50
2006 Q1	1.73	1.21	0.70	118	2.50	4.75	4.50
Q2	1.85	1.28	0.69	114	2.75	5.25	4.50
Q3	1.87	1.27	0.68	118	3.00	5.25	4.75
Q4	1.91	1.30	0.68	112	3.50	5.50	5.00
2007 Q1	1.91	1.32	0.69	105	3.75	5.50	5.00
Q2	1.93	1.35	0.70	100	3.75	5.50	5.00
Q3	1.83	1.30	0.71	97	3.75	5.25	5.00
Q4	1.83	1.30	0.71	95	3.75	5.00	5.00

Key Central Bank Monetary Policy Meeting Dates in 2006

Bank of England	5 th October, 9 th November, 7 th December
US Federal Reserve	24 th October, 12 th December
European Central Bank	5 th October, 2 nd November, 7 th December

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