

Interest and Exchange Rate Forecast

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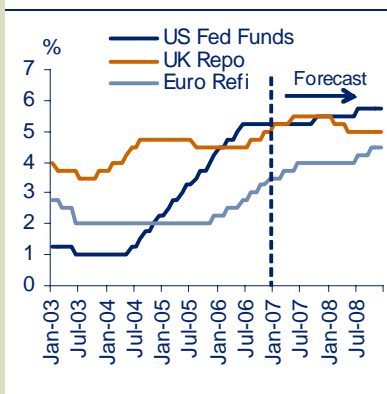
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Interest Rate Forecast

Source: Thomson Datastream/RBS Group Economics



Interest Rates

The UK's Monetary Policy Committee (MPC) maintained the Bank Rate at 5.25% following its February meeting. We think this represents a pause, rather than a peak, but the hazy outlook for inflation means there is considerable uncertainty about what happens next. Our forecast, which is broadly consistent with the MPC's latest projections for inflation and economic growth, includes one more quarter-point rate hike in Q2 (May, or possibly April) followed by two cuts in the first half of 2008 (to 5%). If inflation proves to be more persistent than expected (accelerating wage growth would be a warning here), the Bank Rate could go higher than 5.5%. Conversely, if economic activity is weaker than expected, it may not get there at all, and could conceivably be lower by the end of the year. This uncertainty suggests that sterling could be in for a bumpy ride in 2007, though our central forecast is still for a gradual depreciation against the euro (see next page).

The Federal Reserve looks set to keep US interest rates on hold at 5.25% in the near term, but further policy tightening is likely before the end of the year. The Fed Chairman's semi-annual monetary policy testimony is always a draw for Fed-watchers, but this time around it contained few surprises. Demand was seen to be strong outside of the housing and auto sectors and the economy is expected to expand at a pace close to its long-run trend in the years ahead. Core inflation is too high for the Fed's liking, but is projected to moderate, though Mr Bernanke acknowledged that inflation risks are skewed to the upside. We think that activity will be soft in the first half of 2007 as the housing market adjustment plays out. However, we believe that growth will rebound strongly in H2 2007, keeping upward pressure on inflation and prompting further policy tightening. After all, financial conditions remain supportive, with low long-term interest rates and a weak dollar, while the labour market is in good shape and the corporate sector is in rude health. We expect the fed funds rate to reach 5.5% by the end of this year and 5.75% by end-2008 (for a detailed forecast for the US economy over the next two years click [here](#)).

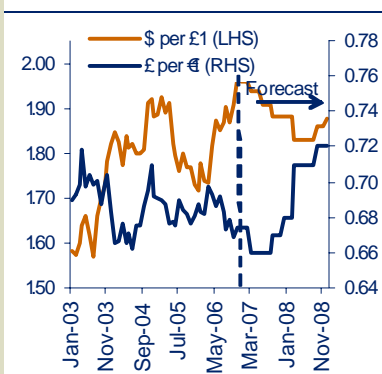
The European Central Bank (ECB) kept interest rates on hold at its February policy meeting. Interestingly, ECB President Trichet used the words 'strong vigilance' at the press conference afterwards. This is code for a quarter-point rate increase at the next meeting in March, which would take rates to 3.75%. Recent data certainly support the case for another rate hike. Economic growth in Q4 2006 surprised to the upside, with the annual growth rate for the year reaching 2.7%. This was the region's best performance since 2000, with all four major countries doing better than most analysts expected at the start of the year. From the ECB's point of view, one implication of faster growth is that there is less spare capacity in the economy, which will keep upward pressure on inflation. This suggests the ECB will continue to move interest rates to a level that is less stimulative. With this in mind, we expect another quarter-point rate increase (to 4%) in Q2 this year with further modest tightening likely next year, with rates ending 2008 at 4.5%.

Exchange Rates

Sterling lost a little ground against the dollar and the euro over the past month as investors marked down their expectations for UK interest rates. Once the Bank of England's tightening cycle ends and as rates head higher in the US and the Eurozone, so

Exchange Rate Outlook

Source: Thomson Datastream/RBS Group Economics



sterling is likely to weaken further – most likely in the second half of 2007 and through 2008. Britain's large trade deficit is also likely to weigh on sterling's exchange rate with the euro once UK interest rates reach their peak (the Eurozone is our largest trade partner). The greenback is likely to gain ground against the euro and sterling as investors come around to our view that further policy tightening is likely in the US. However, the extent of the gain is likely to be limited by ongoing concerns about the enormous US current account deficit. Indeed, once US rates approach their peak in 2008, the dollar is likely to weaken once more against all the major currencies.

The yen hovered close to twenty-year lows against the other major currencies in recent weeks. The Bank of Japan tightened monetary policy on February 21st but, at 0.5%, interest rates are still only a fraction of those in the other major economies, hence the move didn't give much of a boost to the currency. Nevertheless, Japanese interest rates are likely to rise further in the years ahead (albeit gradually), which should lead to a steady appreciation of the yen against the other major currencies. There is a risk of a sharper upward move, however. Many investors have been borrowing money in Japan at very low interest rates and investing the funds in countries where interest rates are much higher (this is often referred to as the "carry-trade"). A sharp appreciation of the yen would expose these investors to losses (as it would cost more to repay the yen denominated loans in foreign currency terms). Indeed, some policymakers are concerned that if investors start to believe such a currency move is likely, it would become self-fulfilling, where a scramble for the exit could lead to turbulence in global financial markets.

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
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	1.96	1.32	0.67	119	3.50	5.25	5.00
2007 Q1	1.94	1.28	0.66	121	3.75	5.25	5.25
Q2	1.91	1.26	0.66	123	4.00	5.25	5.50
Q3	1.88	1.26	0.67	118	4.00	5.25	5.50
Q4	1.88	1.28	0.68	115	4.00	5.50	5.50
2008 Q1	1.83	1.30	0.71	115	4.00	5.50	5.25
Q2	1.83	1.30	0.71	110	4.00	5.50	5.00
Q3	1.86	1.34	0.72	105	4.25	5.75	5.00
Q4	1.88	1.35	0.72	105	4.50	5.75	5.00

Key Central Bank Monetary Policy Meeting Dates in 2007

Bank of England	8 March, 5 April, 10 May, 7 June, 5 July, 2 August, 6 September, 4 October, 8 November, 6 December
US Federal Reserve	21 March, 9 May, 28 June, 7 August, 18 September, 31 October, 11 December
European Central Bank	8 March, 12 April, 10 May, 6 June, 5 July, 2 August, 6 September, 4 October, 8 November, 6 December

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