

Interest and Exchange Rate Forecast

29th February 2008

Contacts:

Robert Gardner (UK)
Group Economics
+44 131 626 3697
robert.a.gardner@rbs.co.uk

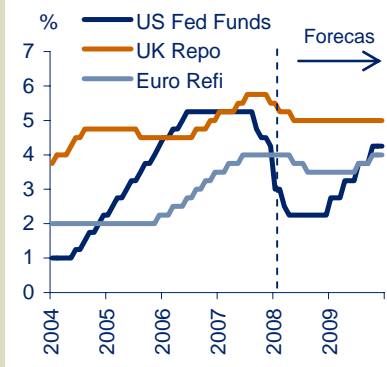
Robert Blotevogel (UK/FX)
Group Economics
+44 131 626 3701
robert.blotevogel@rbs.co.uk

Julien Seetharamdoo (US)
Group Economics
+44 131 626 3925
julien.seetharamdoo@rbs.co.uk

Robbie Denoon (EZ)
Group Economics
+44 131 626 3874
robbie.denoon@rbs.co.uk

Interest Rate Forecast

Source: Thomson Datastream/RBS Group Economics



Interest Rates

The Monetary Policy Committee (MPC) lowered the Bank Rate by 25bps to 5.25% at its February meeting, acknowledging the slowdown in the UK economy. Surveys suggest that activity remained sluggish in the manufacturing and service sectors in January while consumer spending has eased on the back of a cooling housing market and higher energy/food costs. There is potential for stronger exports to provide support, given the more competitive level of sterling, but only if the US and the Eurozone don't slow more abruptly than we anticipate. Futures markets point to another 75bps of easing by the end of the year, but for the moment, this looks optimistic. The minutes of the February meeting suggest that the MPC is willing to accept a marked slowdown in growth in order to contain inflationary pressures. (CPI inflation was running at 2.2% y/y in January and is projected to move further above the 2% target in the months ahead, reflecting increases in utility costs.) We expect one more cut in the Bank Rate to support activity, most likely in May.

Data over the past month point to a US economy that is likely to see very weak growth in H1, perhaps even a recession. Consumer confidence has weakened significantly, suggesting consumer spending growth in the first quarter is likely to slow as well. Business activity indicators are also soft. In particular, the non-manufacturing ISM survey fell twelve percentage points in January, to 41.9, the lowest reading since September 2001, and well below the 50 mark which divides expansion from contraction. The survey covers private sector service activity as well as construction, which together represent around 70% of the US economy. It is therefore likely that the Federal Reserve will continue to cut interest rates, despite the fact that there are still inflationary pressures in the system. Consumer prices rose 0.4% in January bringing the annual inflation rate to 4.4%, up from 4.1% in December. We expect another 50 basis point cut at the 18th March meeting, bringing the Fed funds rate to 2.50%, with a further reduction of at least 25bps likely in April. Recent comments from key US policymakers suggest that rates may remain at a low level for some time.

In the Eurozone, the growth/inflation trade-off continues to give the European Central Bank (ECB) a headache. Economic growth dipped to 2.2% in the final quarter of the year (close to its long-term trend rate) but below the average for 2007 (2.7%). Growth was mixed across the region, with the Netherlands and Spain leading the way while Germany and France both slowed sharply. According to the purchasing managers' indices (PMIs), manufacturing is holding up better than services, but confidence in both sectors has fallen considerably in recent months. However, inflation remained elevated at 3.2% in January – well above the 2% target ceiling, suggesting that the ECB will remain reluctant to cut rates in the near term. However, given that the global backdrop is becoming more challenging and inflationary pressures are expected to ease later in the year, we now expect that rates will be cut by 50 basis points, most likely with one quarter-point cut in Q2 and another in Q3, bringing rates to 3.5%.

Exchange Rates

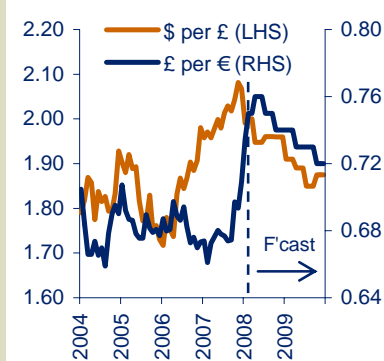
February was a calmer month in foreign exchange markets. Sterling remained relatively stable against the greenback and the euro over the month. A series of speeches by MPC members and the inflation report convinced markets that the chances of large rate cuts (like those seen in the US) are very slim indeed. In the near term, the MPC's reluctance to cut rates aggressively should lend support to sterling, as investors continue to favour currencies with higher interest rates over lower yielding ones.

But risks for sterling vis-à-vis the dollar appear skewed to the downside. Question marks loom over the resilience of consumer spending and external demand in the UK. If these components do not hold up as currently expected, the MPC could be forced to lower rates, which would weigh on the pound. The risk profile of sterling/euro is less clear cut. Both currency areas are in a similar position, with 'hawkish' central banks and indications of softening activity. At this point, the most probable outcome is a few more months of sterling weakness, before the pound regains some (but not all) of the ground lost in recent quarters.

Despite some signs of weakness in the Eurozone, the euro has retained its luster for investors. The euro broke through the \$1.50 barrier for the first time on 27th February, as we anticipated. However, further sharp rises will be hard to achieve. There is little doubt that more US rate cuts are in the pipeline, and the current dollar/euro exchange rate already reflects this. If our view is correct and the ECB is forced to cut rates from Q2 onwards, we should see the euro losing ground vis-à-vis the dollar.

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
2007 Q1	1.96	1.33	0.68	118	3.75	5.25	5.25
Q2	2.01	1.35	0.67	123	4.00	5.25	5.50
Q3	2.04	1.42	0.70	115	4.00	4.75	5.75
Q4	1.99	1.46	0.73	112	4.00	4.25	5.50
2008 Q1	2.00	1.50	0.75	106	4.00	2.50	5.25
Q2	1.95	1.48	0.76	105	3.75	2.25	5.00
Q3	1.96	1.47	0.75	102	3.50	2.25	5.00
Q4	1.96	1.45	0.74	100	3.50	2.25	5.00
2009 Q1	1.91	1.40	0.74	100	3.50	2.75	5.00
Q2	1.89	1.38	0.73	98	3.50	3.25	5.00
Q3	1.85	1.35	0.73	95	3.75	3.75	5.00
Q4	1.88	1.35	0.72	95	4.00	4.25	5.00

Key Central Bank Monetary Policy Meetings in 2008

Bank of England	6 March, 10 April, 8 May, 5 June, 10 July, 7 August, 4 September, 9 October, 6 November, 4 December
US Federal Reserve	18 March, 30 April, 5 August, 16 September, 29 October, 16 December
European Central Bank	6 March, 10 April, 8 May, 5 June, 3 July, 7 August, 4 September, 2 October, 6 November, 4 December

This material is published by The Royal Bank of Scotland plc ("RBS") which is authorised and regulated by the Financial Services Authority for the conduct of regulated activities in the UK. It has been prepared for information purposes only and does not constitute a solicitation or an offer to buy or sell any securities, related investments, other financial instruments or related derivatives ("Securities"). It should not be reproduced or disclosed to any other person, without our prior consent.

This material is not intended for distribution in any jurisdiction in which its distribution would be prohibited.

Whilst this information is believed to be reliable, it has not been independently verified by RBS and RBS makes no representation, express or implied, nor does it accept any responsibility or liability of any kind, with regard to the accuracy or completeness of this information. Unless otherwise stated, any views, opinions, forecasts, valuations, or estimates contained in this material are those solely of the RBS Group's Group Economics Department, as of the date of publication of this material and are subject to change without notice. Recipients of this material should make their own independent evaluation of this information and make such other investigations as they consider necessary (including obtaining independent financial advice), before acting in reliance on this information.

This material should not be regarded as providing any specific advice. RBS accepts no obligation to provide any advice or recommendations in respect of the information contained in this material and accepts no fiduciary duties to the recipient in relation to this information.