

Interest and Exchange Rate Forecast

31st March 2008

Contacts:

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

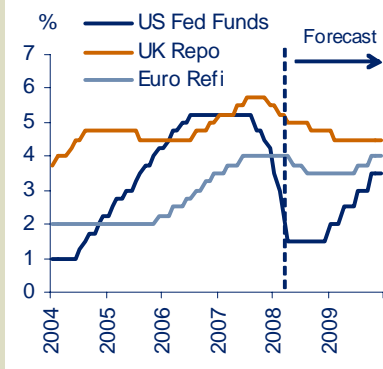
Robert Blotevogel (UK/FX)
Group Economics
+44 131 626 3701
robert.blotevogel@rbs.co.uk

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 UK's Monetary Policy Committee (MPC) left the Bank Rate at 5.25% at its March meeting. Nevertheless, it looks increasingly likely that the MPC will have to lower rates more aggressively to ensure the UK achieves a soft landing. Tensions have re-emerged in money markets, and a lower Bank rate is needed to offset this tightening in financial conditions. The interest rate that banks charge each other for three month loans (LIBOR) has risen sharply again (from 5.6% in early February to 6% at the end of March), which threatens to feed through to the cost of funds for households and businesses. Moreover, at 5.25% the Bank Rate is still acting as a drag on activity, even though the economy is growing below its trend rate. Inflation risks have not completely dissipated. CPI is already above the 2% target and is expected to rise towards 3% in the months ahead. However, this is being driven by rising food/energy prices. Underlying inflation remains subdued and inflation should fall back later in the year as the rises in food/energy fall out of the index. We expect the Bank Rate to be lowered by 25bps in April and August taking it to 4.75% by the end of 2008 and to 4.5% in early 2009.

The Federal Reserve cut interest rates by 75bps on 18th March, bringing the fed funds rate to 2.25%. In the accompanying statement, the phrase "the Committee will act in a timely manner as needed to promote sustainable economic growth and price stability" was reinstated, having been absent from the Jan 22nd (emergency) and 30th (scheduled) rate cut statements. In other words, the Fed is focusing back on its dual mandate of growth *and inflation*, rather than being solely concerned about growth. The renewed reference to inflation may also have been a signal to financial markets that the Fed is concerned about too rapid a depreciation of the dollar. However, the economic data continue to point to an economy that is close to stalling, and may even fall into recession. Consumer confidence was at its lowest level for five years in March according to the Conference Board's survey, and retail sales growth has also slowed. The downturn in the housing market is also continuing. As a result, we now expect further policy easing, with the fed funds rate expected to fall to 1.5% by the middle of the year.

The European Central Bank (ECB) is not in easing mode yet, with policymakers opting to keep rates on hold at 4% in March. The tone of recent data releases suggests that it will take a few months at least before the ECB shifts its stance. First and foremost policymakers are concerned about the inflation outlook. CPI reached 3.5% y/y in March well above the ECB's 2% target ceiling. Moreover, the economy has shown some signs of resilience in recent weeks. Even though the euro is close to all time highs against the dollar and sterling, the negative impact on exports has been partly offset by strong demand from Central/Eastern Europe and Asia. Resilience in Germany is offsetting weakness in southern Europe, which is likely to push back any decision to lower rates. Nevertheless, the Eurozone economy will continue to slow in the months ahead as external conditions remain challenging and as the strong currency takes its toll. Inflationary pressures should also start to subside as economic growth eases, giving the ECB the necessary room to loosen policy. We expect two 25bps rate reductions in the latter half of the year, taking rates to 3.5% by the end of 2008.

Exchange Rates

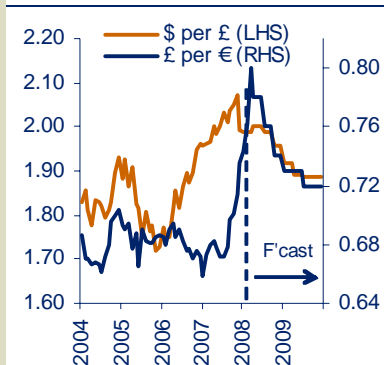
The pound has slipped a little further against the euro in recent weeks as nervousness returned to foreign exchange markets. Structural factors are playing a role. The UK has a large trade deficit and more competitive pound is needed to help close the gap. Investors also expect UK interest rates to be lowered more aggressively in the months ahead, further reducing the allure of UK assets. Taken together, these factors explain the pound's ongoing weakness against the euro. Nevertheless, sterling is likely to make up some ground in the latter half of the year as the ECB switches into 'easing mode' and starts to lower Eurozone interest rates.

The dollar's slide against the euro and the yen has continued in recent weeks although sterling has been trading water against the greenback, hovering around \$2.00. The euro/dollar flirted with the \$1.60 mark, 8% weaker than the start of the year. Yen/dollar also reflects the current greenback woes, with the dollar falling below ¥100 for the first time in twelve years on 13th March. Policy-makers from all major countries have expressed discomfort with the present situation. A sliding dollar could pose a threat to the Fed's inflation target (by making imported goods more expensive) while it hurts exporters in the Eurozone and in Japan.

Rumours of official intervention have started to circulate, but even if implemented the chances of success appear slim. The turnover in foreign exchange markets is now over \$3 trillion a day, so it will not be easy to turn the tide. The downbeat outlook for US domestic demand and the fragile sentiment in financial markets almost surely require further rate cuts by the Fed, denting the appeal of dollar assets. Only when the US economy recovers will a bounce back against the euro become likely. This scenario should start to play out in the latter half of the year, but dollar weakness is likely to persist until then at the very least.

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	1.99	1.59	0.80	99	4.00	2.25	5.25
Q2	2.00	1.56	0.78	99	4.00	1.50	5.00
Q3	1.99	1.51	0.76	98	3.75	1.50	4.75
Q4	1.96	1.45	0.74	95	3.50	1.50	4.75
2009 Q1	1.92	1.40	0.73	95	3.50	2.00	4.50
Q2	1.89	1.38	0.73	93	3.50	2.50	4.50
Q3	1.89	1.36	0.72	90	3.75	3.00	4.50
Q4	1.89	1.36	0.72	90	4.00	3.50	4.50

Key Central Bank Monetary Policy Meetings in 2008

Bank of England	10 April, 8 May, 5 June, 10 July, 7 August, 4 September, 9 October, 6 November, 4 December
US Federal Reserve	30 April, 25 June, 5 August, 16 September, 29 October, 16 December
European Central Bank	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.