

Interest and Exchange Rate Forecast

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Contacts:

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

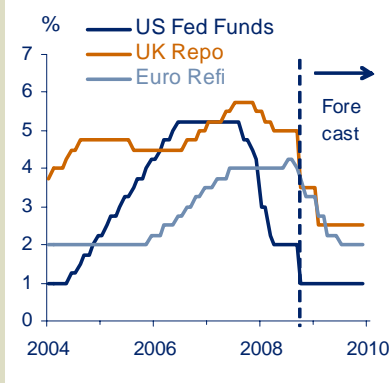
Robert Blotevogel (UK/FX)
 Group Economics
 +44 131 626 3953
robert.blotevogel@rbs.co.uk

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

Robbie Denoon (EZ)
 Group Economics
 +44 131 626 3873
robbie.denoon@rbs.co.uk

Interest Rate Forecast

Source: Thomson Datastream/RBS Group Economics



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Interest Rates

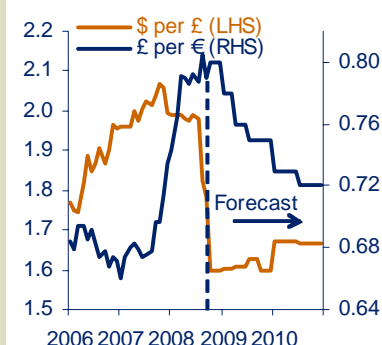
In a co-ordinated move, the Bank of England joined five other central banks (including the US Fed and the ECB) in lowering policy rates by 50bps in October. Activity in the UK is now officially declining, with the economy contracting by 0.5% q/q in Q3. All three major segments – manufacturing, construction and services – saw output declines, the latter at its fastest in pace in 18 years. Leading indicators point to further retrenchment in the corporate sector in the months ahead. Consumers have proved surprisingly resilient to date (retail spending in September was still up 2.3% y/y), but spending is likely to fall as the labour market weakens. Thankfully, inflation concerns are fading, creating room for an aggressive policy response. Commodity prices, the main driver of the recent inflation spike, have staged an across-the-board retreat. Further sizeable rate cuts are expected, with 50bps reductions in November and December, taking rates to 3.5% by the end of the year. We expect rates to reach generational lows of 2.5% in 2009.

The Federal Reserve cut US interest rates by another 50bps at the end of October, after a 50bps cut at the start of the month. The fragility of the financial system and weakness in the real economy made a further rate cut inevitable. Investors were convinced of the need for a move and disappointing market expectations when confidence remains so fragile would have been a very risky strategy. The S&P 500, the main equity market index, is down almost 40% since the beginning of the year and while there has been some reduction in interbank lending rates, credit markets continue to operate under significant stress. News from the non-financial part of the economy has also been downbeat. Employment declined by 159k in September, the largest drop in over five years. What's more, retail sales spending has been extremely weak on the back of consumer confidence slumping towards all-time lows. With the US economy likely to have started to contract in Q3 and inflationary pressures receding (gasoline prices saw their largest ever decline in October), a prolonged period of low interest rates is the most likely scenario. We expect rates on hold at 1% through the rest of this year and through 2009, although the Fed may come under pressure to lower rates even further.

In the Eurozone too, growth concerns have superseded worries about inflation. As a result, the ECB bit the bullet and cut rates by 50bps in October, in the same co-ordinated move as the Fed and the Bank of England. This is likely to prove to be 'too little, too late' to stave off recession. Industrial production across the region has been falling for four months. Ireland is already in recession and others look set to follow. Germany, the region's largest economy and the world's largest exporter, looks particularly exposed to the global slowdown. The IFO and ZEW surveys, good leading indicators of German growth, are at or close to record lows. The downturn in the Spanish housing market is gathering pace and a heavily indebted Italian government has limited scope to boost spending. We expect the region as a whole to contract in 2009, pushing worries about a potential wage price spiral off the agenda. The ECB is likely to cut rates further in the months ahead – we expect rates to be lowered to 2% by next summer.

Exchange Rate Outlook

Source: Thomson Datastream/RBS Group Economics



Exchange Rates

Volatility erupted anew in currency markets, as the economic outlook became even more uncertain. The pound came under intense pressure towards the end of October, falling to a six-year low against the greenback (\$1.54). Significant dollar gains suggest that investors continue to favour the US currency in times of crisis. The yen was the exception, rising sharply against the dollar, to a multi-year high of ¥91. Paradoxically, this move was also driven by risk aversion. Investors scrambled to buy the Japanese currency in order to repay yen-denominated debt that had been borrowed at very low interest rates to invest in riskier, higher yielding currencies. With interest rates in all major regions outside Japan set to fall, there are few worthwhile destination currencies left. Recent currency re-alignments could mark a move towards fundamentals. For example, the dollar had looked weak on some long-term valuation measures (e.g. the exchange rate that broadly equates the price of goods across economies, purchasing power parity, is estimated to be around €1.20 and £1.55 to the dollar respectively).

Given the uncertain economic outlook, volatility is likely to remain high and forecasts are subject to even larger margins of error. The recent sharp fall in sterling reflects investors' increasing pessimism towards the UK outlook. With so much bad news already priced in, we do not expect the pound to retreat much further, with modest gains likely against the euro. Indeed, the euro continues to trade at elevated levels, in spite of the prospect of a Eurozone recession and a sustained period of low interest rates. A further sharp rise in the yen from these levels is unlikely - this would probably prompt intervention by Japanese policy-makers to limit the damage to Japanese exporters.

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
2008 Q1	1.99	1.58	0.80	100	4.00	4.25	5.25
Q2	1.99	1.58	0.79	106	4.00	2.25	5.00
Q3	1.78	1.40	0.79	106	4.00	2.00	5.00
Q4	1.66	1.31	0.79	98	3.25	1.00	3.50
2009 Q1	1.64	1.28	0.78	98	2.75	1.00	2.50
Q2	1.64	1.25	0.76	95	2.25	1.00	2.50
Q3	1.63	1.22	0.75	95	2.00	1.00	2.50
Q4	1.62	1.20	0.74	95	2.00	1.00	2.50
2010 Q1	1.64	1.20	0.73	93	2.00	1.50	3.00
Q2	1.64	1.20	0.73	93	2.00	2.00	3.25
Q3	1.67	1.20	0.72	90	2.25	2.50	3.75
Q4	1.67	1.20	0.72	90	2.75	3.00	4.00

Key Central Bank Monetary Policy Meetings in 2008/2009

Bank of England	6 Nov, 4 Dec, 8 Jan, 5 Feb, 5 Mar, 9 Apr, 7 May, 4 Jun, 9 Jul, 6 Aug, 10 Sep, 8 Oct, 5 Nov, 10 Dec
US Federal Reserve	16 Dec, 28 Jan, 17 Mar, 29 Apr, 24 Jun, 11 Aug, 22 Sep, 4 Nov, 15 Dec
European Central Bank	6 Nov, 4 Dec, 15 Jan, 5 Feb, 5 Mar, 2 Apr, 7 May, 4 Jun, 2 Jul, 6 Aug, 3 Sep, 8 Oct, 5 Nov, 3 Dec

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