

Interest and Exchange Rate Forecast

September 2009

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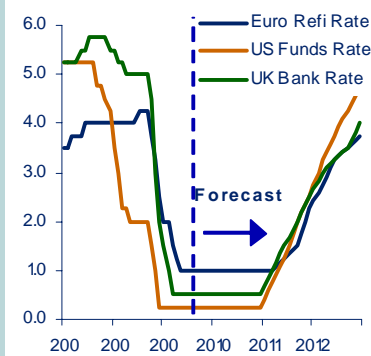
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Interest Rate Forecast (in %)

Source: Thomson Datastream/RBS Group Economics



Interest Rates

UNITED STATES: Economic data over the past month have confirmed the economy is gradually recovering from a deep recession. Consumer confidence is improving, and rising house prices in May, June and July - the first increases since mid-2006 - are helping households repair their balance sheets. Business investment has also stabilised and industrial production rose m/m in both July and August, suggesting production declines have bottomed out. A certain amount of slack in the economy, from lower output and higher unemployment (9.7% in August), means inflation is likely to remain subdued for some time. Indeed, with prices in August 1.5% lower than a year ago, the Fed is likely to be more concerned about deflation.

At its September meeting, the FOMC noted that "economic activity has picked up following its severe downturn," FedSpeak for 'the recession has ended and the recovery has begun.' It also noted that activity is likely to remain subdued for some time and take up of spare capacity in the economy would be gradual. Interest rates were left on hold, where they are likely to remain for a considerable time, and the Fed confirmed it would purchase \$200bn of agency debt and \$1.25trillion of mortgage backed securities by the end of Q1 2010.

UNITED KINGDOM: It looks as though the recession will "officially" be declared over in Q3 as the economy appears on course to record positive growth for the first time since Q1 2008. Q2 GDP was revised up to -0.6%, and the National Institute of Economic and Social Research (NIESR) estimates that in the three months to August the economy expanded by 0.2%. However, growth remains weak. In Q2 the only sector of the economy that did not contract was Government spending. Net exports provided some support, but this was a result of demand at home falling by more than demand abroad.

Inflation remains persistently high (at 1.6% in August), in stark contrast to the US and Euro area where consumer prices have been falling for a number of months. Although this is in part due to a much weaker pound than last year increasing the price of imported goods, it raises concerns over higher inflation further out. That said, the Bank of England is unlikely to change its course on interest rates any time soon as growth should remain sluggish for much of next year and this will maintain downward pressure on inflation. Its other policy tool, asset purchases, could be expanded if considered necessary, but for the time being QE will continue up to £175bn as planned.

EURO AREA: Various indicators point to signs of emergence from recession for the region as a whole in Q3. The PMIs, good leading indicators of activity, stabilised in September in positive territory, and industrial new orders are increasing. However, the breakdown of Q2 growth figures suggest too much reliance remains on government fiscal stimulus measures that have propped up the economy. Government spending was the biggest driver of economic growth in Q2. Other sources of final demand are lacklustre and net exports could continue to be a drag on growth as a result of the stronger euro.

Unlimited liquidity provided to the banking system by the European Central Bank has pushed the cost of borrowing over short horizons below the Refi rate. This hasn't been

enough to stem the fall of M3 money growth as credit to the businesses and households has fallen. The euro area needs to see a return to borrowing and investment before economic growth can return on a sustainable basis, meaning the ECB is likely to retain interest rates at current lows throughout this year and next.

Exchange Rates

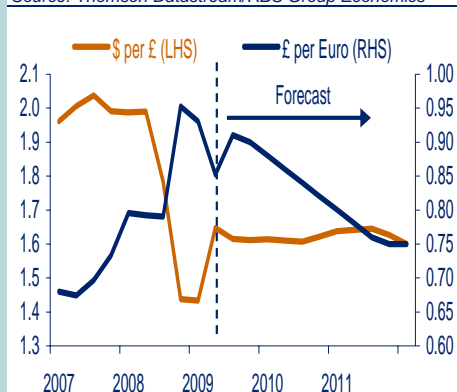
Ultra-low interest rates have led to the dollar becoming the funding currency of choice for investors in global markets. As a result the greenback has continued to weaken against a number of currencies. But a reduction in risk appetite, or market expectations for normalisation of rates could lead to the dollar regaining some strength in the months ahead.

Currency movements in the last month were also influenced by speeches from central bankers, as much as anything else. Mervyn King, Governor of the Bank of England could be considered the instigator of the fall in sterling towards the end of the month: The pound fell to a five-month low against the euro (€1.08), and fell 5 cents against the dollar to \$1.58, before recovering a little by the end of the month.

Markets interpreted King's comment that "The fall in the exchange rate that we have seen will be helpful..." to mean the central bank was comfortable with a weaker pound. Mr King also made the point that a weaker pound would support a shift in resources to the export sector, and so help the UK economy rebalance to a more sustainable growth model, less reliant on consumer spending than in recent years. Going forward, we have not changed our view on the long-term position of the pound vis-à-vis the dollar and euro, but the starting position has changed following recent movements.

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)			
	\$/£	\$/€	¥/\$	\$/CAD	Fed Funds Rate	10Y US Treasury	Euro Refi Rate	UK Bank Rate
2008 Q1	1.98	1.56	102	1.03	2.25	3.45	4.00	5.00
Q2	1.99	1.58	106	1.01	2.00	4.00	4.00	5.00
Q3	1.77	1.40	106	1.06	2.00	3.85	4.25	4.50
Q4	1.44	1.39	91	1.25	0.25	2.25	2.50	2.00
2009 Q1	1.44	1.32	99	1.26	0.25	2.71	1.50	0.50
Q2	1.65	1.41	96	1.16	0.25	3.53	1.00	0.50
Q3	1.60	1.46	91	1.07	0.25	3.30	1.00	0.50
Q4	1.61	1.45	92	1.10	0.25	3.40	1.00	0.50
2010 Q1	1.61	1.42	93	1.13	0.25	3.45	1.00	0.50
Q2	1.61	1.39	94	1.15	0.25	3.60	1.00	0.50
Q3	1.61	1.35	95	1.16	0.25	3.85	1.00	0.50
Q4	1.62	1.33	95	1.14	0.25	4.00	1.00	0.50

Key Central Bank Monetary Policy Meetings in 2009

Bank of England	8 Oct, 5 Nov, 10 Dec
US Federal Reserve	4 Nov, 15 Dec
European Central Bank	8 Oct, 5 Nov, 3 Dec