

Interest and Exchange Rate Forecast

October 2009

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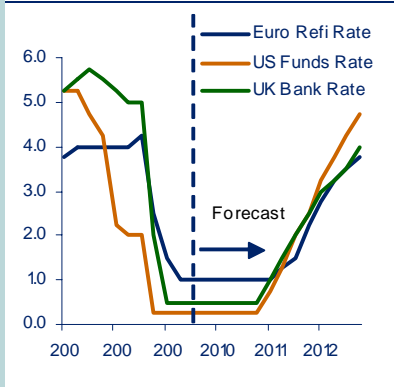
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Interest Rate Forecast (in %)

Source: Thomson Datastream/RBS Group Economics



Interest Rates

UNITED STATES: Recent economic data have confirmed the economy is gradually recovering from a deep recession. Consumer confidence is improving thanks to rising house prices in May, June and July (the first rises since mid-2006). This has restored some of the wealth previously lost, helping households to repair their balance sheets. Business investment has also stabilised and industrial production rose m/m in both July and August, suggesting production declines may have finally bottomed out. After such a deep downturn, there will be slack in the economy (the unemployment rate at 9.8% in September illustrates that available labour resources are significant). This in turn means that inflation is likely to remain subdued for some time.

Indeed, the release of the minutes from the latest rate-setting meeting indicates that the Fed still has concerns about deflation in the economy. The committee noted that although the recent data on consumer price inflation had been a little above expectations, "most participants anticipated that slack in both labor and production markets would be substantial over the next few years, leading to subdued and potentially declining wage and price inflation." So, despite the recent improvement in economic activity, there is no indication that the Fed will be in any rush to raise interest rates.

UNITED KINGDOM: There is a chance that the UK economy will manage positive growth in Q3 for the first time since the start of 2008. Even so, output and spending growth are both likely to remain weak for some time. The National Institute of Economic and Social Research's (NIESR) monthly estimate of GDP suggests growth in the three months to September was flat, pointing to the end of the recession rather than the beginnings of a robust recovery. Indeed, business surveys point to a pickup in the service sector but continued torpor in industrial production.

Consumer price inflation, the key metric targeted by the Bank of England, dropped sharply in September to 1.1% (from 1.6%). Nevertheless, these positive readings contrast with deflation (falling prices) in the euro area and the US. This is largely due to the weakness of sterling, which puts upward pressure on the prices of imports. The MPC is unlikely to raise interest rates any time soon, as the weak growth outlook points to a sustained period of low inflation as exchange rate effects drop out.

EURO AREA: Investors took heart from news that the region's two largest economies returned to growth in Q2. In September, business surveys - good leading indicators of activity - stabilised at levels consistent with positive growth. But the breakdown of Q2 growth figures caution against over-optimism, with too much of a reliance on fiscal stimulus measures, many of which will soon expire. Other sources of demand remain lacklustre and are likely to remain so for some time - for example, exports will remain under pressure from the stronger euro. As well as keeping rates low, the European Central Bank has been providing unlimited liquidity to the banking system to support lending. This hasn't stemmed the slowdown of M3 money growth, as credit to businesses and households has fallen. Concerns that this de-leveraging process will weigh on growth, mild deflation and the strong euro, all suggest that the ECB will retain interest rates at current lows.

Exchange Rates

Currency movements over the last month were heavily influenced by central bankers' comments, especially in sterling's case. Mervyn King, Governor of the Bank of England commented that, "The fall in the exchange rate that we have seen will be helpful". 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. These appear to have been interpreted to mean the central bank was comfortable with a weaker pound, and sterling fell to a seven-month low against the euro (£0.93), and fell 5 cents against the dollar to \$1.58.

Investors appeared to favour the euro over the dollar as well as sterling, as it strengthened 6 cents against the greenback, rising from 1.42 at the start of September to 1.48 in mid-October. The single currency was bolstered by the stronger tone of European economic data, which as noted above, offered the promise of an earlier return to form. This would also have appealed to investors as it reduces the risk that further quantitative easing would be needed, limiting other long-term risks to the currency.

In terms of the outlook, we expect the pound to strengthen against the euro in the medium term, but short-term risks remain. The UK is likely to be one of the main beneficiaries of a recovering global economy – UK goods and services remain relatively cheap compared to exports from the euro area and the US. This could give significant support to the UK's trade balance, potentially providing a significant medium term support for sterling. On the risk side, a large chunk of the UK's public deficit is likely to be financed by overseas investors, exposing the pound to fickle investor sentiment.

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	92	1.07	0.25	3.30	1.00	0.50
Q4	1.61	1.45	90	1.10	0.25	3.40	1.00	0.50
2010 Q1	1.61	1.42	88	1.13	0.25	3.45	1.00	0.50
Q2	1.61	1.39	86	1.15	0.25	3.60	1.00	0.50
Q3	1.61	1.35	84	1.16	0.25	3.85	1.00	0.50
Q4	1.62	1.33	92	1.14	0.25	4.00	1.00	0.50

Key Central Bank Monetary Policy Meetings in 2009

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

Exchange Rate Outlook

Source: Thomson Datastream/RBS Group Economics

