

# Global Economic Outlook

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## Down but not out

There was a time when the prospect of \$100 oil and a sinking dollar were the preserve of "what if" scenarios. Now they are central features of the economic environment that confronts us. Dealing with these challenges won't be easy, and a tough year lies ahead. But policymakers are on the front foot and emerging markets could yet prove to be the developed economies' white knight.

**In the industrialized economies, conditions will be challenging in the first half of 2008.** Financial markets will remain unsettled as the extent of the losses from the US subprime debacle continues to emerge. However, prompt and aggressive policy action has generally proved a powerful tonic to financial crises. Liquidity has been injected into banking systems, while the Federal Reserve and the Bank of England have cut interest rates. This should hasten a return to form in H2 2008.

**Surging food and energy prices may limit the room for maneuver.** Robust demand from emerging markets has pushed the prices of many commodities towards all time highs, with oil prices recently flirting with \$100 per barrel. This poses an upside inflation risk that could curb policymakers' willingness/ability to further trim rates if market conditions take another turn for the worse. We are optimistic that this constraint will be eased next year, at least when it comes to oil prices, as supply catches up with softening demand (see p7).

**Emerging markets will play a key role in keeping the global economy ticking over** and resolving global liquidity problems. Half of world growth since 2000 has come from emerging markets – a trend that looks set to accelerate. Liquidity "infusions" from emerging markets, like sovereign wealth funds' recent investments in the US and in Europe, are helping to ease the liquidity squeeze in the developed world.

**Allowing greater exchange rate appreciation is likely to be part of a long-term solution.** This would take the heat out of inflated asset markets in emerging Asia and the major oil producing nations (charts 1 & 2) and help to ease growth back to more sustainable rates. It would also boost growth in the industrialized world by lifting export competitiveness. A run on the dollar is in nobody's interest - further sharp falls would be likely to prompt coordinated action by international policy-makers (see p2 for discussion of exchange rates).

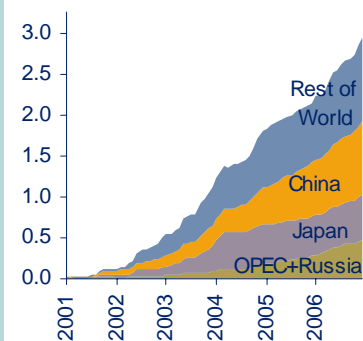
**This does not mean the world economy will escape unscathed.** Even if financial markets settle soon, the credit pendulum will probably swing back too far, with credit availability remaining tighter than it should. This will restrain growth in the developed world and prolonging the US housing correction - a major dragging anchor on the world's largest economy. Slower growth in the developed world will dent developing economies' exports, especially if their exchange rates are allowed to rise. Nevertheless, this would still be far from a full-blown global recession.

**GDP growth forecasts (%)**

	2007	2008	2009
US	2.1	2.2	2.8
Eurozone	2.5	1.9	2.2
UK	3.2	2.0	2.2
Japan	1.9	1.5	2.1
Emerging Asia	9.3	9.2	8.3

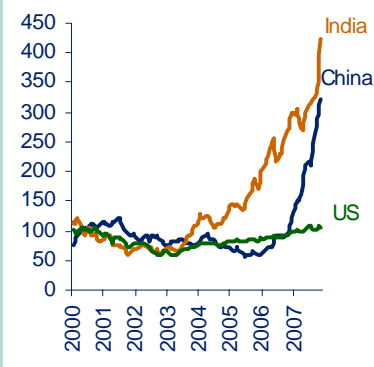
**Chart 1: FX reserve growth 2001 to 2007 (\$ trillion)**

Source: Thomson Datastream



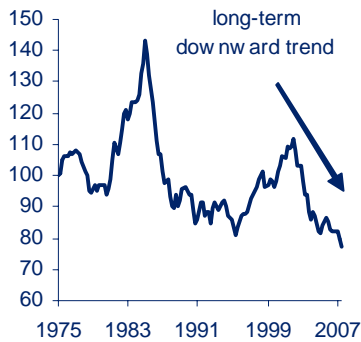
**Chart 2: Asset prices have surged in many emerging markets (Stock Market Indices 2000=100)**

Source: Thomson Datastream



**Chart 3: Dollar trade-weighted index (rebased 1975 = 100)**

Source: Thomson Datastream



**Chart 4: Sterling against dollar and on trade-weighted basis**

Source: Thomson Datastream



## Box: What's going on with exchange rates?

The dollar has fallen to all-time/multi-year lows against a number of the world's leading currencies in recent months, including the pound (26-year low) and euro (all-time low). This raises a number of important questions. What is driving dollar weakness and how long will it persist? Could volatility in foreign exchange markets have a destabilising effect on the world's major economies?

### Causes of the dollar's decline - cyclical and structural

The immediate driver of the dollar's decline is cyclical, driven by concerns about the outlook for the US economy and corporate profitability, on the back of the housing market and sub-prime crisis. This has led the US Federal Reserve to cut interest rates to stimulate the economy and stabilise the financial system. Put simply, lower interest rates and corporate profits make investing in US assets (such as bonds and equities) less attractive relative to assets denominated in another currency, encouraging international investors to sell dollars. There are also more fundamental structural reasons why the dollar is declining related to the size of its trade deficit and the gradual loss of its role as a reserve currency.

### Consequences of a weaker dollar

Why is the dollar's weakness a potential concern? The most obvious effect is that exports from other countries are more expensive in dollar terms, harming competitiveness. This not only affects exports to the US, but also exports to countries in Asia and the Middle East – as many of these countries currently peg their currencies to the dollar (whether formally or informally). However, it is important to put these effects into context. For the UK, even the wider “dollar-zone”, still receives a relatively small share of total UK exports. The US accounts for 13% of UK goods exports, rising to around 18% when we take into account the countries that peg their currencies to the dollar (e.g. China), and to about 21% if we add in those countries whose exchange rates are managed against the dollar (e.g. India). For the Eurozone too, the dollar-zone bloc is an important but not critical export market. Although the euro has appreciated significantly against the dollar, it has not appreciated as much against the currencies of other trading partners. Most Eurozone countries' exports go to other Eurozone countries.

### Middle East countries may abandon/revalue their dollar peg

For Middle East countries, the inflow of petro-dollars combined with the dollar-peg has put upward pressure on inflation and is starting to distort their economies. Worse, the US Federal Reserve is easing monetary policy at a time when the booming oil economies of the Middle East need higher interest rates. The challenges facing the Gulf States are in many ways similar to those of China. Inflationary pressures are building and an asset bubble is rapidly developing as the imported liquidity has fuelled a construction boom, and driven up real estate and equity prices. 2008 could well see many Middle East countries abandoning (or at least revaluing) their peg with the dollar.

### Policymakers are also concerned by 'violent' moves in exchange rates

Policymakers are also concerned about the prospects of rapid or large movements in currencies because of the wider disruptive impact this can have on financial markets and the real economy. Violent swings in currencies make it harder for exporters to agree prices, therefore dampening world trade.

In addition, if a currency appears to a 'one-way bet' this can encourage speculative activity and negatively affect asset markets such as bond markets and equities. For example a very sharp fall in the dollar's value could start to generate its own momentum, leading investors to take money out of US stock and bond markets. This would affect other stock markets and raise the cost of finance across the globe, as most long-term finance is still priced directly or indirectly off the 10-year treasury yield. For this reason policymakers are concerned about disorderly movements in currencies. Therefore while an orderly decline in the dollar would not be a concern for the global economy and is in fact an important part of the global and domestic rebalancing process, violent swings in FX markets would present more of a concern for the outlook in 2008 (RB).

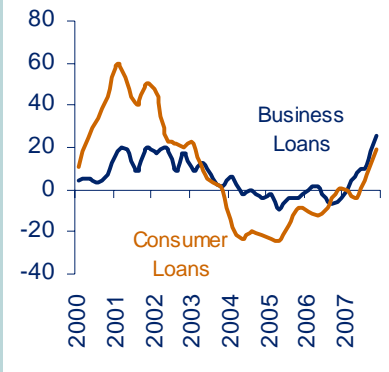
**US: Main macro economic forecasts**

	'07	'08	'09
Real GDP % y/y	2.1	2.2	2.8
CPI Inflation % y/y	2.7	2.4	2.0
Unemployment %	4.8	4.9	4.9
Curr Acc/GDP %	5.6	5.0	4.7

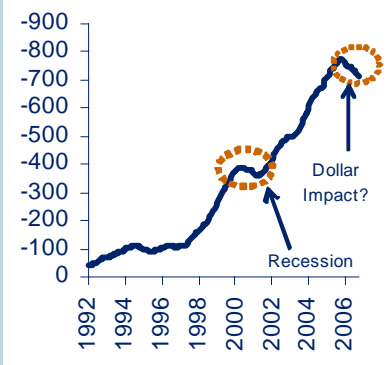
Source: RBS Group Economics

**Chart 5: Net percentage of banks tightening lending standards on loans**

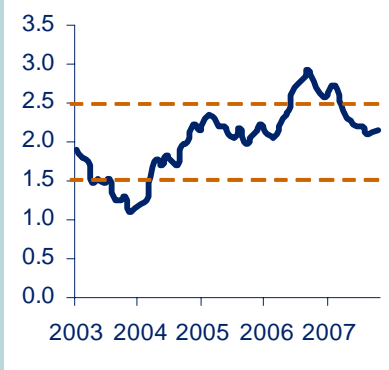
Source: Senior Loan Officer Survey

**Chart 6: Trade deficit finally heading in the right direction**

Source: Thomson Datastream

**Chart 7: Inflation back in the Fed's comfort zone**

Source: Thomson Datastream

**US – Fed on tenter hooks**

The US will have to navigate some difficult terrain in the months ahead. Businesses and households face elevated energy prices and more challenging financial conditions in the wake of the liquidity crunch. Moreover, the wrenching adjustment in the housing market will continue through 2008. Nevertheless, rate cuts already implemented should help insulate the real economy from the worst of the financial turbulence and help credit markets to gradually “normalize”.

A more robust trade performance, aided by a competitive dollar, will also cushion the blow from weaker consumer spending. But this will not be enough to lift the US out of a second year of sub-trend growth. We expect sluggish growth of 2.2% next year, marginally higher than this year's estimated 2.1% pace, before returning to trend (c2.8%) in 2009.

**On a firm footing when the liquidity crunch hit**

Despite financial market turbulence in August/September, the US economy put in a robust performance in Q3, growing by 4.9% (annualised), and a remarkable 6% outside of housing. Unfortunately, the impact of more restrictive credit conditions only really fed through to the economy in Q4, just as surging energy costs took a bite out of consumers' incomes and firms' profit margins. As a result, growth may have fallen below 1% in Q4. The triple headwinds of tighter financial conditions, higher energy costs and the ongoing housing adjustment will continue to act as a drag on growth in the first half of 2008.

The slowdown is likely to be most pronounced in the household sector, but we still expect moderation rather than a collapse in expenditure next year. So long as the labour market remains in good shape, with the economy generating around 75,000 jobs a month, households should be able to accommodate a respectable level of spending as well as a gradual increase in saving that will bolster their financial position. Even if national house prices decline modestly, this shouldn't deliver a knockout blow. Households typically spend between 3% and 5% of wealth gains – therefore any losses should also have a modest impact. Moreover, the equity market is holding up well, all things considered, providing some ballast to balance sheets and confidence. The S&P500 was just 4% below its all time highs in early December and does not look overvalued by conventional measures.

**Investment and trade to the rescue?**

Given the lack of spare capacity in the economy and that companies are highly profitable, business investment should remain firm next year. Survey data suggest service sector activity is relatively buoyant, although output has slowed in the factory sector in recent months. However, order books continue to expand, suggesting manufacturing production should rebound early next year (inventory levels are still lean). Indeed, corporate balance sheets are in good shape, with debt at comfortable levels and adequate cash in hand, suggesting that companies can cope with a short period of more challenging conditions.

The most positive aspect of the outlook relates to trade. Exports have emerged as a key driver of activity, contributing around one percentage point to growth in Q2 and Q3 – a pattern that looks set to be maintained next year. Weaker household spending should restrain import growth. On the export side, demand for US goods will be supported by robust growth in key export markets like Canada, the Eurozone (where domestic demand is finally picking up) and in Asia. At the same time, a weaker dollar is boosting US competitiveness, helping US producers gain market share and reducing the trade deficit.

**Fed poised to step in again and will be more aggressive if required**

Policymakers hoped that the 75bps of policy easing implemented between September and October would be sufficient to insulate the real economy from the fallout of the liquidity squeeze. However, renewed credit market turbulence in November and further evidence of slowing economic activity suggest that policymakers will err on the side of caution and lower the fed funds rate by another quarter point to 4.25% (probably in December). This should be sufficient to ensure the economy picks up in 2008. However, if financial market conditions deteriorate further, we believe the Fed will act aggressively, injecting funds into the financial system in the first instance, and if this failed to settle markets, by further trimming rates. Underlying inflation has fallen back towards 2%, close to the policymakers' preferred level, suggesting that there is scope for further rate cuts if required (RG).

**UK: Main macro economic forecasts**

	'07	'08	'09
Real GDP %	3.2	2.0	2.2
CPI Inflation %	2.3	2.0	1.9
Unemploy %	5.4	5.7	6.0
Curt Acct/GDP %	-2.9	-2.6	-2.5

Source: RBS Group Economics

**Chart 8: UK G7's star performer**

Source: Datastream

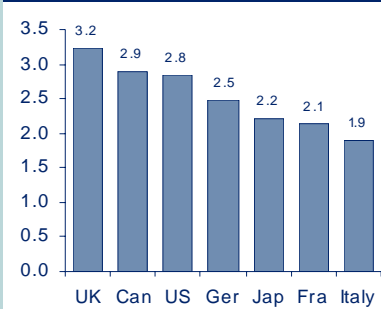
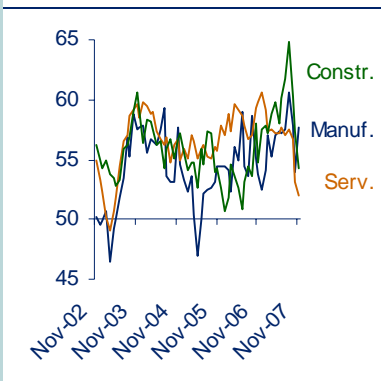


Chart shows real GDP growth over the year to Q3 2007 by G7 country.

**Chart 9: PMIs fall sharply**

Source: NTC Research



>50 implies business activity expanding;  
<50 implies it is contracting

## UK - Time to batten down the hatches?

The UK economy has been the G7's star-performer in 2007, growing by 3.2% over the year to Q3 (see chart 8). But it is likely to fall back into line with the rest of the pack in 2008, as the lagged effect of five rate hikes and the turmoil in financial markets take their toll on activity. We expect GDP growth of 2% next year, though the risks are skewed to the downside. Lower interest rates should help to deliver a re-acceleration, but not until 2009.

Our expectations were not especially high at the start of the year; interest rates were on their way up and fiscal policy was also set to tighten. But the UK proved surprisingly resilient in 2007, growing by 3.2% y/y in Q3, the fastest rate since 2004. This helped propel corporate profitability to its highest level since records began in 1989. That's the good news.

### Loss of momentum in Q4

Now for the bad news: leading indicators point to a marked loss of momentum in Q4. The purchasing managers' indices (PMIs) of business activity in manufacturing, services and construction all fell sharply at the beginning of the fourth quarter (see chart 9). Retail sales growth has also softened. The question is: does this downturn represent a temporary blip or the start of a slowdown in economic activity? We think the latter. Let us be clear that we are not talking about an especially sharp slowdown by historic standards. But compared with this year, 2008 will feel a lot more subdued.

The main reason for the slowdown is the increase in the cost of borrowing for households and companies. Three-month LIBOR (London interbank offered rate) is an important benchmark for much lending, and is one percentage point (100 bps) higher than it was a year ago. This partly reflects the fact that the policy rate is higher. But the turmoil in financial markets has also been a factor, as the threat that some of the associated risks would flow back to banks' balance sheets caused inter-bank markets to tighten. This has inflated three-month LIBOR by one percentage point, according to our estimates, compared with around 10 bps pre-turmoil.

### Households under pressure

Consumer spending will slow as higher mortgage rates squeeze take-home pay and dampen activity in the housing market (we expect prices to be flat over the next 12-18 months). Some relief will come from the MPC, which we expect to cut interest rates twice in the first half of 2008, though note that it typically takes a year for looser monetary policy to boost demand. Further, heightened uncertainty about the future will probably lead to a (temporary) increase in precautionary saving. The UK corporate sector is in good financial shape, though the weaker outlook for profitability will surely affect investment.

The prospects for exporters seem somewhat brighter, as speculation about rate cuts has pulled sterling down to a four-year low against the euro in Q4 (€1.39). Given that the eurozone accounts for around half of UK exports, this boost to competitiveness will be a welcome tonic for the UK economy. The effect on real GDP growth (and inflation, for that matter) will depend on the pricing behaviour of UK and Eurozone companies (i.e. do they try to protect market share or profit margins).

### Risks

The relatively bright outlook for net trade in our forecast presupposes that the global economic backdrop does not deteriorate markedly in 2008. This is a significant risk for an "open" economy like the UK (trade accounted for 28% of GDP last year, and inward/outward flows of foreign direct investment are also large). The US arguably poses the biggest threat. The UK has domestic concerns too. The housing market has garnered most column inches, and Bank of England Governor Mervyn King recently sounded the warning bell on equity prices, but higher-than-expected inflation could be a worry too. Global commodity prices are in the ascendancy, as are food prices. Inflation expectations have been well behaved in recent years, but that could change. The outlook for economic growth will be much bleaker if inflation worries mean that the MPC is unable to cut the Bank Rate or, indeed, forced to raise it (**David Fenton**).

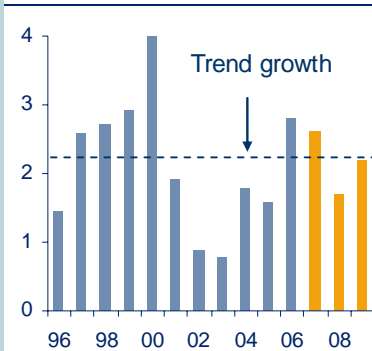
### Eurozone: Macro economic forecasts

	'07	'08	'09
Real GDP % y/y	2.6	1.7	2.2
CPI Inflation %/y	2.1	2.4	1.9
Unemploy. %	7.4	7.3	7.4
Curr. Acct/GDP %	0.0	-0.1	0.0

Source: RBS Group Economics

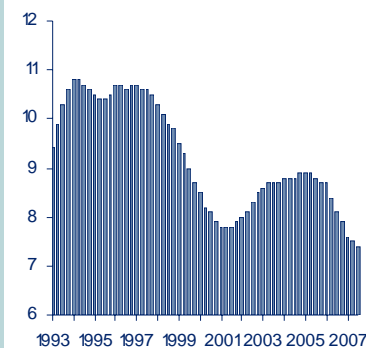
#### Chart 10: Eurozone GDP Growth back towards trend

Source: Thomson Datastream



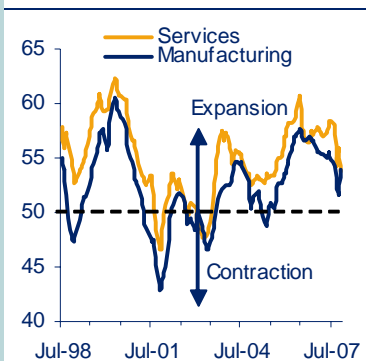
#### Chart 11: Unemployment has fallen sharply (% Labour Force)

Source: Thomson Datastream



#### Chart 12: Eurozone PMIs: Manufacturing leads services in downturn

Source: Thomson Datastream



## Eurozone – Catching a cold?

After the strongest growth performance in six years in 2006 and a strong first half in 2007, the summer credit squeeze marked the high-water mark for the Eurozone in the current business cycle. Business and consumer confidence, while still at reasonable levels, fell sharply over the summer. A strong performance in Q3 has done nothing to alter our expectations of a slowdown in Q4 and in H1 2008.

### Slower growth ahead despite strong Q3 performance

Eurozone GDP growth rebounded strongly in Q3 (0.7% q/q) after a weak Q2. The economies of Germany, France and Spain all expanded by 0.7% q/q. Italian growth was slower at 0.4%. But taking Q2 and Q3 together the Eurozone as a whole only grew at a trend-like pace over the middle part of 2007, compared to an above-trend pace at the beginning of the year. What's more, the latest monthly data and survey evidence point to an abrupt slowdown in growth in Q4.

The decline in confidence started in the manufacturing sector, with services confidence holding up better. Unfortunately, manufacturing typically responds more quickly to a downturn and therefore although it represents only around 30% of most advanced economies (40% for Germany) is a closely watched indicator for predicting turning points in the cycle. We therefore expect the overall pace of economic activity to soften too. It appears that whereas the region was able to withstand a US housing market correction in the first half of the year, the credit squeeze has highlighted the financial linkages between the US economy and Europe.

### But structural improvements and lower unemployment will cushion the blow

However, it is important to recognise that structural changes in Germany in particular have raised its long-term trend growth rate. Labour markets are more flexible, and unemployment has fallen sharply. The Eurozone is also benefiting from strong growth in emerging markets and in Eastern Europe. For this reason, after a slowdown in H1 2008, we expect a pickup in activity in the second half of 2008, as the fallout from the financial market crisis fades and if the US economy emerges from two years of below trend growth.

### Impact of euro strength

Exchange rate movements muddy the picture and present further downside risks for the Eurozone. The euro has hit a series of all-time highs against the dollar. But we think this risk has been exaggerated by some commentators. It is important to analyse the strength of a currency on a trade-weighted basis in order to gauge the true impact on the economy. On this basis, the appreciation of the euro has not been as great because the dollar has been weakening against a number of currencies. At its recent peak, the euro had appreciated by 13% against the dollar in twelve months, but was only 5% stronger on a trade-weighted basis.

### ECB - barking not biting

The European Central Bank (ECB) raised interest rates twice in the first half of the year, reaching 4.0% in June, but had to shelve plans for a further increase in September because of the turmoil in financial markets over the summer. Some members of the governing council have continued to make hawkish noises because of upside risks to inflation and the fact that policy rates are still accommodative, but in the current environment the chances of further rate hikes anytime soon are slim. The most likely scenario is a prolonged period of rates on hold, with a chance of a rate cut, should downside risks materialise.

### Growth rotating away from construction boom economies to competitive ones

Interest rates are low by historical standards, but those economies which have been propelled by housing market booms (e.g. Spain and Ireland) are still likely to be affected by the increase in rates from their post World-War II low of 2% between June 2003 and December 2005. Conversely, the German economy, which has managed to substantially improve its competitiveness through structural reform should continue growing at a decent pace. This should also benefit its neighbours, with whom trade linkages are closest (JS).

## Asia decoupling - not complete but on its way

Asia GDP Growth forecasts (% y/y)

	2007	2008	2009
Japan	1.9	1.5	2.1
China	12.0	10.5	9.5
India	8.6	8.3	8.0

Source: RBS Group Economics

Chart 13: GDP Growth

Source: RBS, Thomson Datastream

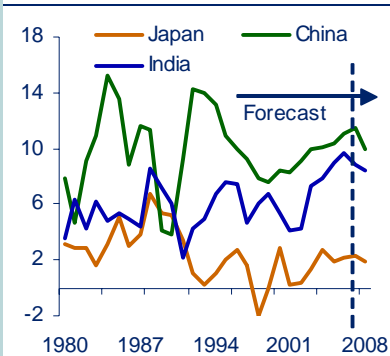


Chart 14: Stockmarket performance (Jan. 2004 = 100)

Source: Thomson Datastream

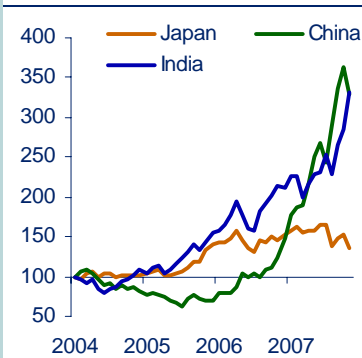
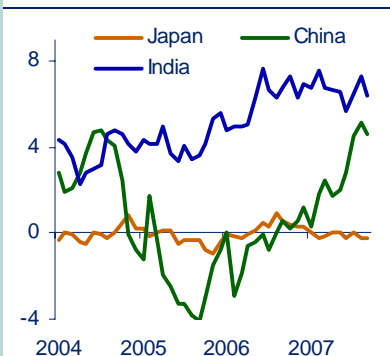


Chart 15: Consumer Price Inflation (% y/y)

Source: Thomson Datastream



While it looks unlikely that the Eurozone will be able to decouple from a US slowdown and global credit squeeze, the situation for Asia is likely to be different. Asian economies are savers rather than borrowers and have been left largely unscathed by the recent woes in financial markets. The rate of economic expansion for Asia ex-Japan remains high at around 9.2% in 2007 (9.3% in 2006). Overheating and the disruptive impact of rising inflation are the near-term risks.

China has cemented its reputation as an economic powerhouse with forecast growth of 10.5% next year, followed closely by India. The main reason for our optimism is the favourable outlook for domestic demand (i.e. consumer spending and investment), despite the likelihood of slowing export markets. In addition, due to improvements in their balance sheets since the Asian crises in 1997/98 and the emergence of domestic debt markets, companies are set to overcome growing capacity constraints by stepping-up their investment expenditure. Asian governments also have the ability to act as a buffer against a deterioration in export demand by increasing government spending, having built up substantial financial reserves.

### China powers ahead due to strong investment spending

For many, China is as close as it gets to a modern economic miracle. Investment spending, industrial production and exports remain the key drivers of growth. Exports and industrial production are growing at around 20% y/y and urban fixed asset investment (e.g. housing and transport infrastructure) are growing 25% y/y.

This shift from investment-led growth to a more consumption oriented economy (like the US) will be a long process. One implication is that the trade surplus will continue to grow, defying the moderating impact from the gradual appreciation of the renminbi. The authorities are likely to raise interest rates further to tackle rising asset and consumer price inflation. Both are running above sustainable levels. CPI inflation reached 6.5% in August (due to high food prices) and the stock market quintupled in value over the last two years.

### India's economy looses a bit of steam, but demand for Indian assets unabated

The second most populous country in the world has recently joined China in the 'Asian growth party'. The economy grew at or above 9% for the last two years, but for this year, we believe that a gradual cooling of the Indian economy is underway, with growth slowing to around 8% next year.

The slowdown is largely an engineered one, as the steady increases in interest rates over the last two year and a half years is felt in the 'real' economy. Indeed, better macroeconomic management makes India a more attractive investment proposition. In addition, while growth is expected to slow, it will be still be very strong, implying strong corporate profit growth going forward too. We therefore expect investors to continue to invest in Indian assets, further boosting the rupee and supporting the already buoyant stock and real estate markets. If inflationary pressures re-emerge in the months ahead, further action from policy-makers may be required.

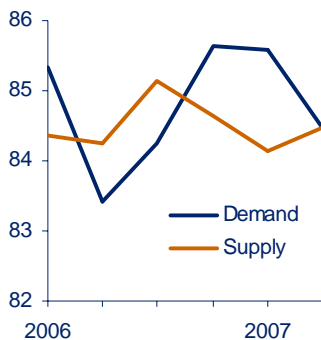
### After a weak H1 2008, Japan's economic recovery should continue

After a 'lost decade' in the 90s and a short recession in 2001, the Japanese economy recovered to grow at around 2% y/y in the last six years. Deflation still looms over the economy, with the latest reading indicating a decline in the CPI of -0.2% y/y. This will stop the Bank of Japan from hiking official rates further from the current paltry level of 0.5% until the second half of 2008. In addition, the pace of economic expansion is likely to decelerate in the first half of 2008 because of the impact of the US slowdown and high commodities prices.

However, beyond that we expect growth to pick as the Japanese economy is in fundamentally better shape than it was in the 1990s. Banks balance sheets have been restored, corporate profitability is strong, and the labour market tight. 2008 could even be the year when Japan finally escapes deflation (**RB**).

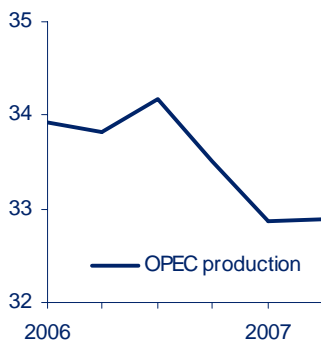
**Chart 16: Oil demand has outgrown supply**

Source: EIA, million barrels per day



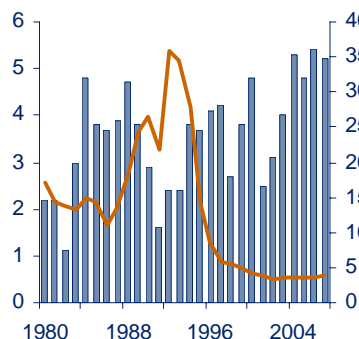
**Chart 17: OPEC rediscovers discipline**

Source: EIA, million barrels per day



**Chart 18: Global inflation & GDP**

Source: IMF



## Oil prices: derailing the global economy?

Crude oil prices have been scaling new record highs in the final quarter of the year rising above \$99 per barrel and may well breach the symbolic \$100-per-barrel barrier. We believe a correction is overdue as slower economic growth in the developed world should result in a downward shift in demand for energy and the persistence of high oil prices make it harder for developing economies to insulate their consumers from high prices. Even if prices stay at current levels, it is important to keep the impact on global growth in perspective.

### What explains the rally in oil?

Demand growth has outpaced supply and spare capacity has fallen as a result (see chart 16) increasing the premium paid to secure supply. OECD inventories fell to just under 53 days of forward coverage in September and hit a 20-year low in Japan. Normally stocks are rebuilt in the third quarter, as demand falls off a little in the lull between the US summer driving season and the northern hemisphere winter. But high prices have had a limited effect on dampening global consumption, because consumers in many emerging markets are insulated from higher prices through subsidies, preventing the price signal from working. Demand has been growing more slowly in the US where price increases are passed on to consumers directly.

### Unresponsive supply

In addition, supply has failed to respond to high prices. One reason is a protracted shortage of drilling equipment and skilled labour, which have caused exploration costs to escalate, ultimately delaying many projects. Investment in reserve development is also severely hampered because the most promising projects are under the control of national oil companies, which are offering unattractive terms to foreign investors. OPEC has also restored discipline, largely because Saudi Arabia, the only producer with significant spare capacity, has exercised restraint (chart 17). This has removed about one million barrels per day from markets, a third of total estimated global spare capacity. The fall in the value of the dollar has also contributed to higher oil prices. OPEC has experienced a decline in the purchasing power of its revenues (which are denominated in dollars) and expects compensation through higher prices.

### Geopolitical risk

The threat of possible supply disruptions continues to exert upward pressure on prices. Increased geopolitical tensions (especially in the Middle East) at a time of limited spare capacity have increased the risk premium embodied in the oil price. Finally, speculative activity has increased substantially in the oil options and futures markets, further pushing up prices.

### Economic impact muted ... so far

If asked a few years ago what the effects of \$100-per barrel oil would be on the US or UK economy, most would have automatically responded with the "R" word, "recession", or even "stagflation" (slowing growth and spiralling inflation). The response this time around is typically more guarded, for two reasons. First, as noted above, the current rally has been mostly demand-driven - in sharp contrast to the supply-side shock that caused the oil crises during the 1970s and early 1980s. Oil prices are a consequence of strong growth. Secondly, developed economies have been boosting energy efficiency and are now much less energy-intensive than 20 or 30 years ago. The shift from manufacturing toward services has further accelerated this trend.

### A supply disruption could derail the global economy

The bigger threat from oil to the global economy in terms of both growth and inflation would come if we had a supply disruption (for example due to a further increase in Middle East tensions). A supply-side shock would represent more closely the circumstances of the 1970s shocks, and could see prices at levels well above \$100 per barrel. If inflation expectations became less well anchored at the same time, then high input costs could also eventually lead to a wage price spiral, leaving central banks with limited ability to cut interest rates to stimulate the economy (**Thorsten Fischer**).

## Interest and Exchange Rate Forecasts

RBS GROUP ECONOMICS INTEREST AND EXCHANGE RATE FORECASTS							
	EXCHANGE RATES (End-of-Period)				INTEREST RATES (%, End-of-Period)		
	\$ per £	\$ per EUR	£ per EUR	\$/JPY	Euro Refi Rate	US Funds Rate	UK Bank Rate
<b>2006 Q1</b>	1.73	1.21	0.70	118	2.50	4.75	4.50
<b>Q2</b>	1.85	1.28	0.69	114	2.75	5.25	4.50
<b>Q3</b>	1.87	1.27	0.68	118	3.00	5.25	4.75
<b>Q4</b>	1.96	1.32	0.67	119	3.50	5.25	5.00
<b>2007 Q1</b>	1.96	1.33	0.68	118	3.75	5.25	5.25
<b>Q2</b>	2.01	1.35	0.67	123	4.00	5.25	5.50
<b>Q3</b>	2.04	1.42	0.70	115	4.00	4.75	5.75
<b>Q4</b>	2.08	1.48	0.71	111	4.00	4.25	5.50
<b>2008 Q1</b>	2.10	1.50	0.72	108	4.00	4.25	5.25
<b>Q2</b>	2.00	1.43	0.72	108	4.00	4.25	5.00
<b>Q3</b>	1.94	1.40	0.72	105	4.00	4.25	5.00
<b>Q4</b>	1.92	1.38	0.72	105	4.00	4.25	5.00

Please see our monthly Interest and Exchange Rate Forecast document for regular updates

Key Central Bank Monetary Policy Meetings in 2007/2008	
<b>Bank of England</b>	10 January, 7 February, 6 March, 10 April, 8 May, 5 June, 10 July, 7 August, 4 September, 9 October, 6 November, 4 December
<b>US Federal Reserve</b>	11 December, 30 January, 18 March, 30 April, 5 August, 16 September, 29 October
<b>European Central Bank</b>	10 January, 7 February, 6 March, 10 April, 8 May, 5 June, 3 July, 7 August, 4 September, 2 October, 6 November, 4 December