

# Interest and Exchange Rate Forecast

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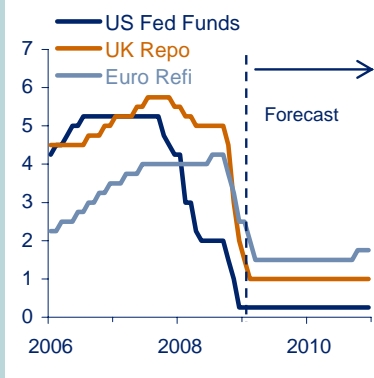
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## Interest Rate Forecast (in %)

Source: Thomson Datastream/RBS Group Economics



## Interest Rates

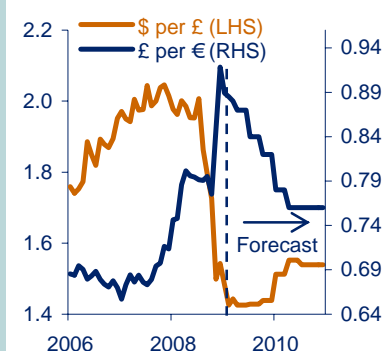
**With US interest rates already at effectively zero, policymakers are pulling out all the stops to try and boost activity.** The steadily worsening economy means that few seriously doubt that a large fiscal stimulus is required. Industrial output and retail sales were both down 10% y/y in January and unemployment rose to a 16-year high of 7.6%. Faced with such dire developments, the Fed now expects the economy to contract by c0.9% this year. Inflation fell to 0% y/y in January and is poised to turn negative – indicators are pointing to a risk of a sustained period of falling prices (deflation). Deflation threatens the onset of a downward spiral, where falling prices lead to ever weaker demand (as people defer purchases) and a rising debt burden. This risk is spurring policymakers into action. The Obama administration signed into law an \$800bn fiscal stimulus package to boost demand. The housing market, still in free-fall, remains a key policy focus. Measures helping to stabilise the market include lowering mortgage repayments, and, in limited circumstances, forgiving some of the debt owed. The Fed is likely to ramp up its ‘unorthodox’ policy-making from here, intervening further in credit markets to lower borrowing costs for people and companies.

**The ECB sat on its hands at its February meeting, keeping the policy rate at 2%.** But we won’t have to wait too long for another cut, given the recent slew of dismal data, all pointing toward a worsening downturn. ECB President Trichet said the Governing Council had factored in further deterioration when they lowered rates in January, but it is hard to believe they anticipated quite how bad things would get. The Euro area economy contracted by 1.5% q/q in Q4, much worse than the -0.2% falls seen in Q2 and Q3. Germany led the race to the bottom (-2.1%) as exports suffered sharp declines, followed closely by France and Italy. Spain also joined the ranks of countries in recession at the end of last year, prompting S&P to remove the country’s coveted AAA rating. Weaker activity continues to put downward pressure on inflation (currently at 1.6%) and may take it into negative territory later this year. Leading indicators show output and employment continuing to wither through February and are consistent with a worsening economic picture. This should be enough to force the ECB’s hand at the March meeting, cutting rates by 50bps (to 1.5%).

**The UK’s Monetary Policy Committee (MPC) cut the Bank Rate by another 50bps to 1.0% at its February meeting.** At the release of the Quarterly Inflation Report, Mervyn King, Governor of the Bank of England, emphasised that future actions will be aimed at increasing the supply of money directly. The minutes of the February policy meeting also revealed the MPC’s view that “solely cutting the Bank Rate” to zero would not be enough to re-flate the economy. This suggests that the MPC will concentrate on alternative measures to stimulate activity and perhaps leave the Bank Rate at 1%. The Bank of England is likely to purchase government debt (to bring down longer-term interest rates) and mortgage securities as well as corporate loans (to lower borrowing costs for the private sector). They will finance these purchases using newly created money, also in the hope that this will spur domestic spending. But the strategy is not without risk. Producers could put up their prices in response to the anticipated increase in money supply, leading to inflation. Admittedly, this danger seems fairly remote at the moment with the UK in deep recession, but it could become a problem when recovery comes.

### Exchange Rate Outlook

Source: Thomson Datastream/RBS Group  
Economics



## Exchange Rates

**Investors' perception of the safety of US markets has taken a hit.** The US government is set to vastly increase the supply of government bonds, and it is unclear who will buy them all. Some fear the Federal Reserve will have to step in as a buyer of last resort, flooding foreign exchange markets with dollars in the process. These fears seem enough to prevent an across-the-board dollar rally that would normally occur in times of high economic uncertainty and investor risk aversion.

**Policy support is at heart of concerns over the euro and the dollar, but for opposite reasons.** When it comes to the euro investors are worried that the region will receive too little policy support, while many believe the greenback could suffer from efforts to boost the money supply. The European Central Bank has staged a much less aggressive response than the UK or US central banks, even though growth prospects are dire. Moreover, the Eurozone has no institutional framework to co-ordinate fiscal policy across countries. This makes investors sceptical how much of a 'safe haven' Eurozone assets really are in the current downturn. We therefore expect the euro to remain under pressure.

**The last four weeks were sterling positive, for a change.** But sterling's 6.5% appreciation against both the euro and the dollar had more to do with intensifying worries elsewhere than a rethink of the prospects for the UK. On a number of counts the pound is still in the same vulnerable position. High debt levels, a significant trade deficit and a reliance on foreign capital inflows are structural imbalances that take years, rather than months, to correct. But the rest of world has serious economic troubles to deal with too, and investors are increasingly shifting their attention to those problems.

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	1.27	90	1.20	0.25	2.90	1.50	1.00
Q2	1.43	1.24	85	1.22	0.25	3.10	1.50	1.00
Q3	1.43	1.20	85	1.28	0.25	3.25	1.50	1.00
Q4	1.44	1.18	90	1.30	0.25	3.90	1.50	1.00
2010 Q1	1.51	1.18	92	1.30	0.25	3.95	1.50	1.00
Q2	1.55	1.18	95	1.25	0.25	4.00	1.50	1.00
Q3	1.54	1.17	95	1.20	0.25	4.30	1.50	1.00
Q4	1.54	1.17	95	1.20	0.25	4.50	1.75	1.00

### Key Central Bank Monetary Policy Meetings in 2008/2009

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