

Interest and Exchange Rate Forecast

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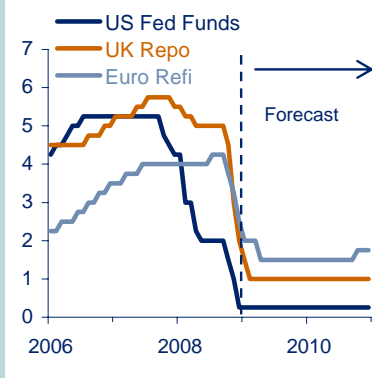
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Interest Rate Forecast (in %)

Source: Thomson Datastream/RBS Group Economics



Interest Rates

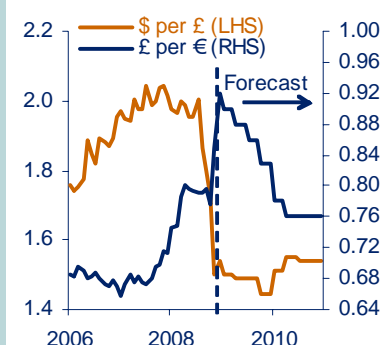
With no scope to cut US short-term interest rates any further, not much happened at the January Federal Open Market Committee (FOMC) meeting. The official statement reiterated that the FOMC will maintain the “exceptionally low levels of the federal funds rate for some time.” This statement is intended to steer market expectations and, hopefully, to reduce longer-term market rates. The description of the economy was understandably downbeat in view of deteriorating economic indicators and sharply rising unemployment, but new to the statement was reference to “a gradual recovery in economic activity [that] will begin later this year.” At the same time the FOMC admitted that “downside risks to that outlook are significant.” A month after the US moved to within a whisker of deflation, downside risks to inflation were deemed to remain. The FOMC reaffirmed its commitment to “employ all available tools” to reflate the economy and avoid deflation, but did not say that it would buy treasuries yet. For the time being it remains focused on purchasing mortgage backed securities and agency debt. Behind the scenes plans to form a “bad bank” or asset guarantee programme are probably advanced, but were not discussed (the FOMC is probably not the correct forum).

The European Central Bank (ECB) cut interest rates for the fourth month on the trot in January, lowering the main policy rate by 50bps to 2.0%. Recent data were so downbeat that postponing a cut was no longer a viable option. Flagging global demand led to Eurozone exports tumbling by 4.7% y/y in November, the fastest pace in eight years – a particularly painful blow to export-oriented Germany. Industrial output is already falling at a breakneck pace and further declines look likely, given the 26% y/y fall in the value of new orders recorded for manufacturing firms in November. Domestic spending is under pressure too, as households pull back in response to a deteriorating labour market. Unemployment in the region is already at a two-year high. National governments have vowed to fight the downturn with all means possible. But investors’ willingness to finance soaring public deficits appears more restrained, as evidenced by the rise in government bond yields of many countries and tepid demand at government debt auctions. The only silver lining is that inflation is moderating, equalling the all-time low of 1.6% y/y in December. With further declines in economic activity and inflation expected, it is hard to see how the ECB can refrain from lowering rates further. We expect rates to be cut by 50bps in Q2, if not before.

The UK’s Monetary Policy Committee (MPC) lowered the Bank Rate by another 50bps to 1.5% at its January meeting, as expected. It is official, the UK is in recession. Economic activity declined for the second quarter running in Q4 2008, by a worryingly large 1.5% q/q. And it’s becoming clearer by the day that the fallout from this financial crisis will be worse than the early 1990s recession. The anaemic state of domestic demand, together with the VAT cut, encouraged retailers to mark down prices to entice shoppers to spend before Christmas. This helped to drive inflation down by a full percentage point to 3.1% in December. With inflationary pressures easing, the Bank of England is resorting to non-traditional measures to fight the recession. The Bank has already announced that it will purchase £50bn of high quality assets to support the corporate sector’s access to funding. We expect one more 50bps cut next month, although policy is likely to increasingly focus on intervention in credit markets to spur activity.

Exchange Rate Outlook

Source: Thomson Datastream/RBS Group Economics



Exchange Rates

Since the end of December, the dollar has risen against the euro and sterling (slightly), but remained broadly flat against the yen after several months of steady gains. On a trade-weighted basis, the dollar weakened slightly on the month, breaking a four month winning streak. A narrowing interest rate spread relative to foreign central banks, as they rushed to lower policy rates, will have aided this decline, and renewed commitment by the Fed to take all available actions to prevent deflation, which could include aggressive quantitative easing, may result in further weakness.

On a trade-weighted basis, the euro is virtually unchanged over the past twelve months. It has lost 12% against the dollar, but gained 26% vis-à-vis the pound. This reflected the belief that the euro area would be less affected by the financial crisis. These hopes have now been dashed, and while the region is unified under a single interest rate policy, there is no mechanism to co-ordinate government expenditure across member states. Obviously, currency moves are impossible for member countries. We think that investors will soon acknowledge the euro area's limited flexibility amid the deteriorating economic outlook, which will translate into a weakening euro in foreign exchange markets.

The past four weeks were difficult for sterling. The consensus is that much of UK bad news— its high current account deficit, its high dependency on financial services and its high indebtedness – are already reflected in sterling's current level. However, the most recent government support package for British banking triggered new weakness in mid-January. While the UK has just started a painful phase of structural adjustments, key trading partners are in a similarly difficult position. This means that negative surprises and shifting investor sentiment are likely to drag on the euro. The pound could make up ground against the dollar, with investors mindful of a US Central Bank on the cusp of running the printing press.

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	1.31	90	1.15	0.25	2.45	2.00	1.00
Q2	1.46	1.30	85	1.22	0.25	2.50	1.50	1.00
Q3	1.48	1.27	85	1.28	0.25	2.65	1.50	1.00
Q4	1.48	1.23	90	1.30	0.25	2.90	1.50	1.00
2010 Q1	1.51	1.18	95	1.30	0.25	3.00	1.50	1.00
Q2	1.55	1.18	100	1.25	0.25	3.20	1.50	1.00
Q3	1.54	1.17	100	1.20	0.25	3.60	1.50	1.00
Q4	1.54	1.17	105	1.20	0.25	3.90	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