

Interest and Exchange Rate Forecast

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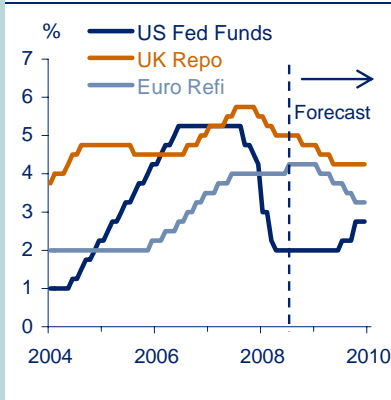
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Interest Rate Forecast

Source: Thomson Datastream/RBS Group Economics



Interest Rates

The US has been at the centre of the storm that unsettled financial markets in September. Following the nationalisation of the two giant mortgage agencies, Fannie Mae and Freddie Mac, early in the month, the US Treasury was forced to bail out several other financial institutions on the brink of insolvency. Treasury Secretary Hank Paulson decided that a resolution to the crisis required emergency legislation from Congress. The aim is to remove the troubled assets from financial institutions' balance sheets that lie at the heart of the current woes. If successful, the plan should gradually help unclog the financial system, and restart activity in credit markets. However, a number of risks remain. It is uncertain when the plan will be operational, given Congress' initial resistance to make the demanded \$700bn available. It is also unclear how effective the plan will be once implemented. Moreover, consumer spending is likely to be extremely weak in the second half of the year, and unemployment will rise further. It is unlikely that the Fed will raise rates soon in this environment. In fact, it is possible that the Fed could cut rates, possibly as part of a global coordinated response amongst central banks, if financial markets suffered a renewed bout of turbulence.

The UK Monetary Policy Committee kept the Bank Rate on hold at 5% once again in September. With the financial market crisis taking a marked turn for the worse in September, the downside risks to growth have clearly intensified. Wholesale funding markets have all but seized up, making it more difficult/expensive for banks to extend credit to households and businesses. This is likely to continue to constrain business investment spending, which has already fallen in the last two quarters. Households are in a similar position. The labour market, until recently the most resilient force in the economy, is weakening, with the unemployment rate ticking up to 5.5% in July (up 0.3 percentage points from January). Household balance sheets are under pressure from falling house and equity prices, reducing the scope for spending. Trade is unlikely to come to the rescue with many key export markets on the brink of recession. With a peak in inflation only a month or two away, the MPC will probably cut rates before the year is out to prevent the crisis in financial markets from morphing into a deep recession. We expect a 25bps cut in November, marking the start of an easing cycle, with further rate cuts in February and May. The risk is more and sooner.

In the Eurozone, leading indicators point towards flat growth at best in the months ahead. The IFO, a survey of 7,000 German businesses, fell to a three-year low, suggesting that the worst is still ahead for the region's largest economy. France and Italy are faring little better with business confidence at five year lows. Lacklustre domestic demand is being compounded by weakening external demand, highlighted by sharply slowing foreign orders across the region. It therefore now looks increasingly likely that Ireland will not be the only country to record a technical recession this year – the Irish economy contracted by 0.5% in Q2 after a 0.3% decline in Q1 as house building and consumer spending slumped. Weaker demand eases inflation pressures. Headline CPI already edged lower in September (3.6% from 3.8% in August). But it is still way above the official target of "below, but close to 2%". The European Central Bank has repeatedly stated that it keeps a strict separation between

liquidity provision to alleviate stress in the financial system and its interest rate policy aimed at maintaining price stability. On this basis, a rate cut is unlikely before next year.

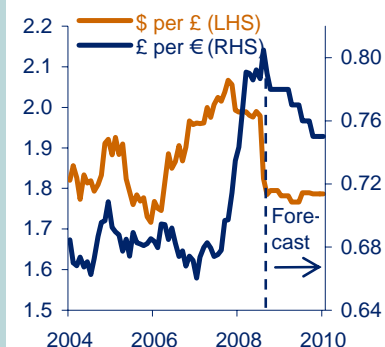
Exchange Rates

The worsening of the credit crisis brought the dollar bounce to an abrupt halt. Between July and mid-September, the dollar strengthened 11% against both sterling and the euro. However, this dollar rally reversed direction swiftly when several key financial institutions in the US were either bailed-out or filed for bankruptcy. Importantly, the nationalisation of Fannie Mae and Freddie Mac added more than \$5tn to the stock of liabilities guaranteed by the US government (note that these liabilities are mostly backed by assets, so that the net addition to US debt is significantly smaller). More government liabilities increased the perceived riskiness of holding US debt, making investors reluctant to buy dollar-denominated assets. As a result, the dollar came under renewed pressure. Against this backdrop, a significant dollar recovery now looks more uncertain than last month.

However, woes in the US can only temporarily distract from deepening difficulties in the Eurozone and the UK. Neither the UK nor the Eurozone were spared from the fallout of the financial crisis this month, with a series of government measures to support ailing financial institutions. What is more, faltering activity in the real economy means that both UK and Eurozone rates will eventually come down to prop up activity – only the timing of the cuts remains uncertain. Expectations of lower rates are likely to start weighing on both the pound and the euro. But the downward pressure is likely to be similar in strength for both currencies, resulting only in modest movements in the pound/euro exchange rate.

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)			
	£/\$	EUR/\$	\$/JPY	\$/CAD	Fed Funds Rate	10Y US Treasury	Euro Refi Rate	UK Bank Rate
2007 Q1	1.96	1.33	118	1.15	5.25	4.65	3.75	5.25
Q2	2.01	1.35	123	1.06	5.25	5.03	4.00	5.50
Q3	2.04	1.42	115	1.00	4.75	4.59	4.00	5.75
Q4	1.99	1.46	112	0.99	4.25	4.04	4.00	5.50
2008 Q1	1.99	1.58	100	1.03	2.25	3.45	4.00	5.25
Q2	1.99	1.58	105	1.01	2.00	4.00	4.00	5.00
Q3	1.86	1.47	105	1.05	2.00	3.80	4.25	5.00
Q4	1.86	1.45	100	1.08	2.00	4.20	4.25	5.00
2009 Q1	1.86	1.43	100	1.10	2.25	4.40	4.25	4.75
Q2	1.86	1.41	98	1.11	2.75	4.30	4.00	4.50
Q3	1.84	1.36	95	1.11	3.25	4.50	3.75	4.50
Q4	1.84	1.34	95	1.10	3.75	4.90	3.75	4.50

Key Central Bank Monetary Policy Meetings in 2008

Bank of England	9 October, 6 November, 4 December
US Federal Reserve	29 October, 16 December
European Central Bank	2 October, 6 November, 4 December