

Interest and Exchange Rate Forecast

28th April 2009

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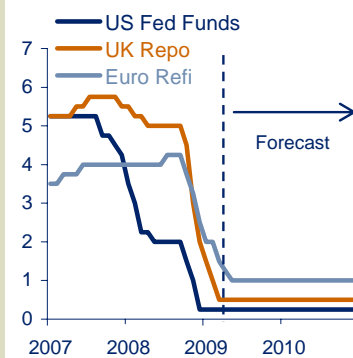
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Interest Rate Forecast (in %)

Source: Thomson Datastream/RBS Group Economics



Interest Rates

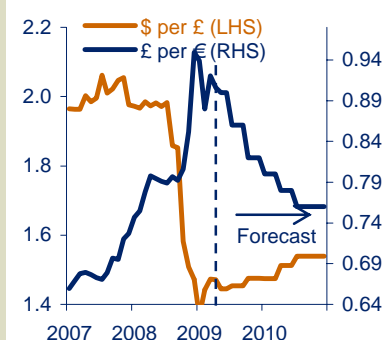
The UK's Monetary Policy Committee (MPC) revealed that its asset purchase scheme was progressing as planned at its April meeting. Of the £75bn available, the Bank of England had already spent £41bn by the end of April, although the Bank acknowledged that it will be several months yet before the full impact is felt across the economy. The bulk of the money flowed into government bonds. Initially, 10-year bond yields dropped sharply, but have since climbed back to 3.5%, roughly the level where they stood before 'quantitative easing' was announced. This reversal is partly due to rising investor concern about the UK's public finances - the 2009 Budget projects government borrowing will reach a record £175 billion (12.4% of GDP) this year with little improvement in 2010. Reactions from corporate bond and commercial paper markets were less marked. Indeed, the difference between the yield on government and corporate bonds has continued to narrow, moderating borrowing costs for large corporates. This will help to cushioning the sector from the ravages of recession, which has continued to intensify in recent months. The UK economy shrank by 1.9% q/q in the first three months of 2009, the steepest rate of decline for three decades.

There were tentative signs that the pace of deterioration in the US is slowing. The ISM manufacturing survey inched higher for a third month in a row in March, though it remains far below the 50 'no change' mark. Importantly, the new-orders sub-index bounced sharply, hinting that demand may be starting to pick up. On the household side, revised retail sales posted surprisingly strong readings. Overall, consumer spending rose by 0.8% q/q in Q1, compared to a fall in of 2.4% between Q3 and Q4. It is likely that Q1 GDP data will show that consumer spending was flat or slightly positive in real terms – a big improvement compared to the rock-bottom expectations for spending at the beginning of this year. But with unemployment already at 8.5% and expected to rise further, the US economy remains in intensive care. The Fed will therefore continue to buy mortgage-backed securities, commercial paper and US government bonds in an effort to unblock credit arteries. Interest rates are likely to remain close to zero for a prolonged period (we don't expect a rate increase before 2011).

The European Central Bank (ECB) lowered interest rates by 25bps to 1.25% in April, and announced it would reveal details of further measures to ease private sector credit in May. Current data highlight the need for additional support. Inflation halved in March to 0.6%, with one quarter of the Eurozone economies already experiencing falling prices (Ireland, Portugal, Luxembourg and Spain). Unemployment rose to 8.5%, from 8.3% in February, and falling industrial production will exacerbate the employment picture in the months ahead. There was a glimmer of hope from business surveys – traditionally a good indicator of future activity. Business expectations in the service sector improved markedly, jumping to levels consistent with expansion for the first time since July 2008. If this is not a return to actual growth, it indicates that the rate of contraction is at least slowing. We expect the ECB to start 'quantitative easing' operations next month, and to cut its main interest rate by another 25bps.

Exchange Rate Outlook

Source: Thomson Datastream/RBS Group Economics



Exchange Rates

Sterling stood firm over the past month, staying put against the dollar and gaining 2% against the euro. The solid performance was particularly notable, given that the last four weeks saw the release of data showing that the recession had intensified and that public finances were deteriorating further than expected. Being able to defy strong headwinds like these reinforced the hypothesis that the pound's exchange rate already reflects downbeat expectations. Put differently, UK vulnerabilities are well understood and rather well discounted in foreign exchange markets. The outlook remains highly uncertain, but in our view, a gradual strengthening from here is the most likely scenario for the pound.

Structural concerns continue to weigh on the euro. The ECB has hinted at the imminent implementation of unconventional policy measures like outright purchases of government and corporate bonds. However, the constraints the ECB faces in these operations are tougher than elsewhere. First, it will be tricky to decide which government bonds to buy – for example, purchasing bonds issued by financially weaker countries like Ireland and Greece could look akin to a bail-out in the eyes of fiscally austere Germany.

Second, unlike in the US and the UK, there is no procedure agreed by eurozone governments of how to indemnify the ECB for any losses it might incur as a result of asset purchases. This could dampen the credibility, and likely effectiveness, of 'quantitative easing' in the euro area. Add into this picture the large exposure of many euro area banks to their ailing neighbours in Central and Eastern Europe, and it becomes clear that there is plenty of potential for negative sentiment to start building towards the euro.

RBS GROUP ECONOMICS INTEREST AND EXCHANGE RATE FORECASTS

	EXCHANGE RATES (end-of-period)				INTEREST RATES (%, end-of-period)		
	\$ per £	\$ per €	£ per €	¥ per \$	Euro Refi Rate	US Funds Rate	UK Bank Rate
2008 Q1	1.98	1.56	0.79	102	4.00	2.25	5.00
Q2	1.99	1.58	0.79	106	4.00	2.00	5.00
Q3	1.77	1.40	0.79	106	4.25	2.00	4.50
Q4	1.44	1.39	0.95	91	2.50	0.25	2.00
2009 Q1	1.46	1.36	0.93	94	1.50	0.25	0.50
Q2	1.44	1.30	0.90	90	1.00	0.25	0.50
Q3	1.45	1.25	0.86	90	1.00	0.25	0.50
Q4	1.48	1.21	0.82	90	1.00	0.25	0.50
2010 Q1	1.48	1.18	0.80	92	1.00	0.25	0.50
Q2	1.51	1.18	0.78	95	1.00	0.25	0.50
Q3	1.54	1.17	0.76	95	1.00	0.25	0.50
Q4	1.54	1.17	0.76	95	1.00	0.25	0.50

Key Central Bank Monetary Policy Meetings in 2009

Bank of England	7 May, 4 Jun, 9 Jul, 6 Aug, 10 Sep, 8 Oct, 5 Nov, 10 Dec
US Federal Reserve	29 Apr, 24 Jun, 11 Aug, 22 Sep, 4 Nov, 15 Dec
European Central Bank	7 May, 4 Jun, 2 Jul, 6 Aug, 3 Sep, 8 Oct, 5 Nov, 3 Dec

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