

# Interest and Exchange Rate Forecast

30<sup>th</sup> May 2008

## Contacts:

Robert Gardner (UK)  
Group Economics  
+44 131 626 3697  
[robert.a.gardner@rbs.co.uk](mailto:robert.a.gardner@rbs.co.uk)

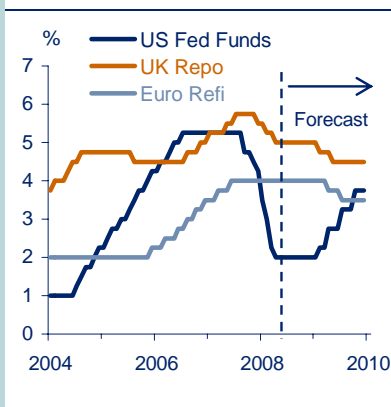
Julien Seetharamdoo (US)  
Group Economics  
+44 131 626 3925  
[julien.seetharamdoo@rbs.co.uk](mailto:julien.seetharamdoo@rbs.co.uk)

David Fenton (EZ)  
Group Economics  
+44 131 626 3701  
[david.fenton@rbs.co.uk](mailto:david.fenton@rbs.co.uk)

Robert Blotevogel (UK/FX)  
Group Economics  
+44 131 626 3701  
[robert.blotevogel@rbs.co.uk](mailto:robert.blotevogel@rbs.co.uk)

## Interest Rate Forecast

Source: Thomson Datastream/RBS Group Economics



## Interest Rates

**The Federal Reserve cut interest rates by 25 bps to 2% on 30th April.** But the recently released minutes of the meeting indicate that further cuts are off the agenda unless the economy takes another severe turn for the worse. Indeed, several FOMC members noted that "it was unlikely to be appropriate to ease policy [...], unless economic and financial developments indicated a significant weakening of the economic outlook." One likely reason for the more 'hawkish' tone of the statement is that the Fed, like the MPC, is becoming increasingly concerned about upside risks to inflation. There are signs that consumers are revising their inflation expectations upwards on the back of record-high petrol prices. This led to a significant shift in market expectations, pricing in rate hikes by the end of this year. We are not as aggressive and expect the Fed funds rate to remain at 2.0% the rest of this year, before edging back up in early 2009.

**The UK's Monetary Policy Committee (MPC) kept the Bank Rate unchanged at 5% at its May meeting.** The decision was at least in part prompted by signs that UK consumers had stood surprisingly firm since the beginning of the year. The first available breakdown of Q1 GDP figures revealed that consumer spending spurred ahead by a very robust 1.3% q/q, equivalent to 3.0% y/y, and well ahead of the disappointing 0.1% q/q at the end to 2007. Retail sales data for April also showed ongoing resilience of the UK consumer. Against this backdrop, it was unsurprising that the MPC directed its focus on the uncomfortably high level of inflation. The April inflation print came in at 3%, exceeding even the most pessimistic forecasters. Inflation reached the upper end of the Bank of England's (BoE) comfort zone earlier than anticipated and it now looks almost certain that Mervyn King, the Governor of the BoE, will be forced to write more than one letter to the Chancellor, explaining why inflation is above target. With high non-core inflation (food and energy), the MPC will be forced to push down on core (domestic) inflation to bring overall inflation back on target two years down the road. This leaves the MPC with scant room for manoeuvre to cut interest rates this year. We have therefore postponed our call of a rate cut until February next year.

**The European Central Bank's (ECB) Governing Council left interest rates on hold at 4% in May.** Some countries in the Eurozone continue to show signs of resilience, particularly Germany, the region's largest economy. In May, the ZEW survey of financial analysts recovered to its highest level since January and the IFO survey remains close to historic highs. However, the purchasing managers' indices point towards slower growth in the Eurozone region as a whole. A 'north-south' divide in the Eurozone is also emerging, with Germany and France doing better than Italy and Spain. Inflation risks in the Eurozone have also increased significantly, given record oil and other commodity prices. Headline inflation in the Eurozone in April was 3.3% y/y, well above the ECB's official 2% ceiling. We therefore do not expect the ECB to cut interest rates until Q2 2009.

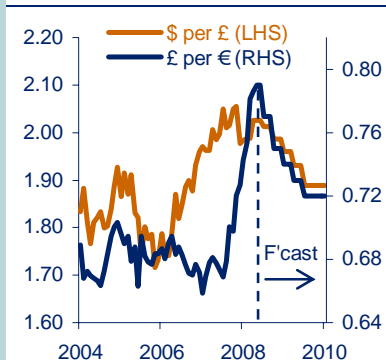
## Exchange Rates

**Foreign exchange markets displayed no clear direction over the past month due to conflicting signs from the main economic areas.** The dollar's movements were a case in point. The greenback rallied noticeably against the euro (from \$1.59 to \$1.53), but also vis-

à-vis sterling (from \$1.99 to \$1.94) on the back of better-than-expected US data in the first week of May. However, in the subsequent weeks, it let go of most of the ground gained, as spiking oil prices took centre stage again, reinforcing investors' concerns about the vulnerability of the US economy to high energy prices. This illustrates an important point – a sustainable dollar rebound is unlikely as long as investors believe that a recession is still a distinct possibility in the US.

### Exchange Rate Outlook

Source: Thomson Datastream/RBS Group Economics



**The pound's movements were another illustration of last month's erratic dynamics in foreign exchange markets**, starting the month off two pence higher against the euro (£0.78), but retreating back to £0.80 since. On the one hand, sterling found support in the news that chances of more rate cuts this year are close to zero. Yet investors still fretted about the UK's structural weaknesses, i.e. the significant current account deficit, the economy-wide momentum of de-leveraging and a deteriorating housing market. While not in the spotlight for now, the risk factors unique to the Eurozone (e.g. regional discrepancies and lukewarm domestic demand) will start garnering more attention. On balance, we expect this process to start in earnest towards the end of year, with sterling strengthening against the euro.

**It is worthwhile to take a step back from short-term exchange rate fluctuations to look at longer-term movements and their implications for economic growth.** On a trade-weighted basis, the dollar is 14% cheaper than it was in January 2007, while sterling depreciated by 12% over the same period. This is part of a long anticipated rebalancing of the global economy and boosts US and UK exporters' competitiveness in global markets. However, trade balances will only improve with a lag of a year or more. It takes time for foreign importers to place new orders, while importers in the US and the UK have to pay up immediately (in domestic currency terms) for still outstanding orders. Therefore, net trade will lend support to US and UK demand in the months ahead, and could be key in steering these economies clear of recessionary waters.

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	2.03	1.60	99	1.03	2.00	4.20	4.00	5.00
Q3	2.01	1.55	98	1.04	2.00	4.30	4.00	5.00
Q4	1.99	1.49	95	1.01	2.00	4.40	4.00	5.00
2009 Q1	1.96	1.45	95	1.02	2.25	4.40	4.00	4.75
Q2	1.93	1.41	93	1.03	2.75	4.50	3.75	4.50
Q3	1.89	1.36	90	1.04	3.25	4.80	3.50	4.50
Q4	1.89	1.36	90	1.03	3.75	5.30	3.50	4.50

### Key Central Bank Monetary Policy Meetings in 2008

Bank of England	5 June, 10 July, 7 August, 4 September, 9 October, 6 November, 4 December
US Federal Reserve	5 August, 16 September, 29 October, 16 December
European Central Bank	5 June, 3 July, 7 August, 4 September, 2 October, 6 November, 4 December