

Interest and Exchange Rate Forecast

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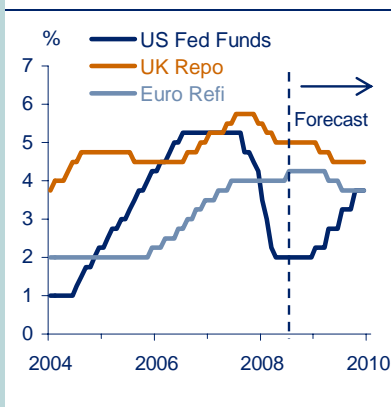
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Interest Rate Forecast

Source: Thomson Datastream/RBS Group Economics



Interest Rates

The next move in US interest rates will almost certainly be up. The US economy is weak, but has so far managed to avoid a contraction. GDP growth in Q1 was revised up (to 1% quarter-on-quarter, annualised) and monthly data for Q2 has been stronger than expected. For example, retail sales in May beat analysts' expectations. However, inflation concerns are increasing. US consumer price inflation rose to 4.2% y/y in May, driven mainly by surging energy prices. The Federal Reserve kept interest rates at 2% at its June 24/25th rate-setting meeting. In the accompanying statement, the Fed recognised that downside risks to growth 'have diminished somewhat' and that 'upside risks to inflation and inflation expectations have increased'. This suggests 2% will be the low point in the current interest rate easing cycle and that rates will be heading higher in the not too distant future. Nevertheless, there is considerable uncertainty over when the first rate hike will come. A step-up in the Fed's 'hawkish' rhetoric does not automatically imply that rate increases are imminent. We think the weakness in the real economy will prevent the Fed raising rates until the turn of the year, though there is a risk it could come earlier if inflation pressures intensify.

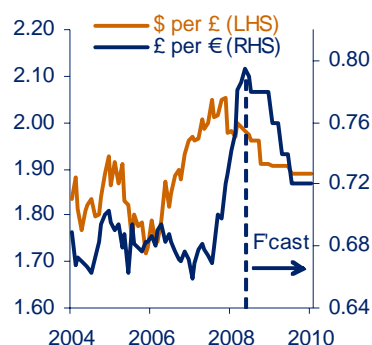
The UK Monetary Policy Committee's (MPC) June meeting provided no surprises, with the Bank Rate held at 5%. The UK economy is slowing, but bringing down inflation is now the MPC's number one priority, since CPI inflation rose to 3.3% in May. As this was more than one percentage point above the 2% target, it required the Governor of the Bank of England to write the first of what is likely to be a series of explanatory letters to the Chancellor. But the letter did not signal imminent rate hikes. Instead, it pointed to international commodity prices, which the Bank of England cannot influence much, as the key driver.

The risk is that higher food and energy prices spill over into the price of other goods and services. This would most likely occur through workers gaining higher wages which businesses try to recoup through higher prices. So far, wage growth has remained within the MPC's comfort zone of below 4%. As long as this remains the case, a 1970s style wage-price spiral remains unlikely. On balance, the risks to growth and inflation are counterbalancing each other, suggesting that the MPC will keep rates on hold. However, retail sales growth surprised to the upside in May, with one of the strongest outturns for 25 years. If this strength is repeated in June/July, the scales will tip towards rate hikes.

The European Central Bank's (ECB) Governing Council left interest rates on hold at 4% in June. However, ECB President Trichet effectively pre-announced a rate hike for next month at the press conference held immediately after the Council's meeting. There were already tentative signs that inflation expectations were edging up, in large part driven by actual CPI inflation moving up to 3.7% y/y in May (from 3.3% in April) – a threat to its credibility which the ECB takes very seriously. The prospect of a rate hike as early as July took markets by surprise, as most investors thought that weakening growth would be enough to bring inflation back to the official 2% target over the medium-term. In light of Mr Trichet's remarks, we have revised our interest rate forecast. We now expect the ECB to hike rates by 25bps in July, with the risk of further increases if inflation expectations continue to move higher.

Exchange Rate Outlook

Source: Thomson Datastream/RBS Group Economics



Exchange Rates

Fed Chairman Ben Bernanke took the unorthodox step of 'talking up' the dollar recently, marking a departure from the Fed's long-held policy of 'benign neglect'. He stressed that although a weak dollar lends support to the US economy by boosting exports (as it makes US exports cheaper in international markets), it also exacerbates inflation pressures, by making imports more expensive. The dollar rallied in response – although this proved short-lived. The ECB's *de-facto* announcement of an imminent interest rate rise just two days later withdrew most of the dollar support. As a result, the dollar was little changed over the month against the euro. This is not to say that Mr Bernanke's comments were not significant – they signal that the US may not stand by idly if the greenback slides sharply again.

Intensifying inflation worries were bad news for the UK economy, but provided support for sterling. In recent weeks, it has become increasingly clear that UK interest rates are unlikely to be lowered further this year and may yet be increased. With UK interest rates already some way above those in the US, Eurozone or Japan, this has increased the attraction of sterling for investors, with the pound climbing to £0.79 against the euro. However, the pound's recovery is unlikely to gain more momentum until the ECB signals that further rate hikes are off the table. The large UK trade deficit also argues against a sharp sterling rebound.

Another notable development over the past month was the yen's renewed slide against the dollar. After strengthening significantly at the turn of the year, the yen has slipped 8% since its peak in March. In addition to the shift in US interest rate expectations, investor risk aversion has diminished, with the 'carry trade' back in favour (where investors borrow in regions where interest rates are low and invest the funds where yields are higher). Economic fundamentals like the large Japanese current account surplus (4.3% of GDP) call for some yen recovery by year-end.

| 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 | 1.96 | 1.53 | 100 | 1.02 | 2.00 | 4.20 | 4.25 | 5.00 |
| Q4 | 1.91 | 1.49 | 98 | 1.02 | 2.00 | 4.40 | 4.25 | 5.00 |
| 2009 Q1 | 1.91 | 1.45 | 95 | 1.02 | 2.25 | 4.40 | 4.25 | 4.75 |
| Q2 | 1.91 | 1.41 | 93 | 1.03 | 2.75 | 4.50 | 4.00 | 4.50 |
| Q3 | 1.89 | 1.36 | 90 | 1.04 | 3.25 | 4.80 | 3.75 | 4.50 |
| Q4 | 1.89 | 1.36 | 90 | 1.03 | 3.75 | 5.30 | 3.75 | 4.50 |

Key Central Bank Monetary Policy Meetings in 2008

| | |
|-----------------------|---|
| Bank of England | 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 | 3 July, 7 August, 4 September, 2 October, 6 November, 4 December |