Group Economics

Interest and Exchange Rate Forecast

4th September 2007

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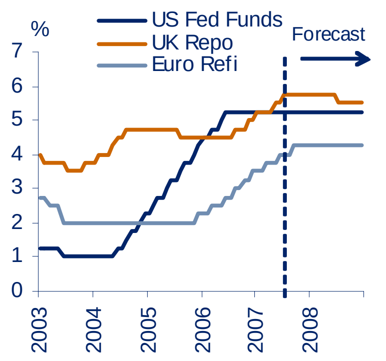
Interest Rate Forecast

Source: Thomson Datastream/RBS Group Economics



Interest Rates

The UK's Monetary Policy Committee (MPC) left the Bank Rate on hold at 5.75% in August. The Minutes of the meeting revealed that the decision was unanimous – for the first time in 2007. Surprisingly, most members emphasized that they had "no firm view" on whether rates would need to rise further. This seemed slightly at odds with the August *Inflation Report*, published the week before, which indicated that one more hike would be required to meet the inflation target. More recently, financial market turmoil has clouded the outlook for the real economy and the future path of interest rates. The unexpectedly sharp drop in CPI inflation in July (to 1.9% - a touch below the MPC's 2% target) suggests that further rate hikes are unlikely in the near term. Moreover, although the Bank Rate has remained on hold, overall financial conditions have become more restrictive in recent weeks as market turbulence has curtailed the availability of credit to the wider economy. On balance, we expect rates to remain on hold for the remainder of the year before heading modestly lower in H2 2008.

Market expectations of three interest rate cuts in the US by the end of the year appear overly aggressive at this point. On 17th August the Federal Reserve cut the penalty rate at which it will lend to banks by 50 basis points. This does not represent an easing of monetary policy for the wider economy (banks rarely borrow directly from the Fed). However, the move demonstrates a willingness to act if market turbulence threatens to disrupt the wider economy. The Fed also released a statement noting that, "tighter credit conditions and increased uncertainty have the potential to restrain economic growth going forward," adding, "the downside risks to growth have increased appreciably." At the same time, the statement maintained that, "recent data suggest that the economy has continued to expand at a moderate pace". The implication is that the risks have risen significantly, but the economy has not yet been impacted much. Clearly, if events take another turn for the worse or there are signs of spillover to the real economy, we can expect a cut in the fed funds rate, although the Fed will be hoping that the measures that it has already taken will be sufficient to shift market psychology and re-establish order to financial markets.

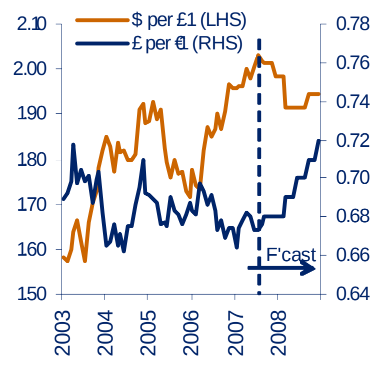
The European Central Bank (ECB) kept interest rates on hold at their meeting on 2nd August, but gave a strong hint that a quarter-point rate increase had been penciled in for the next meeting in September. However, since then turmoil in financial markets prompted the ECB to inject a record amount of funds into the banking system. If market conditions settle, then another increase, to 4.25%, is still likely before the end of the year (possibly as early as September or October). Thereafter, we expect the ECB to keep rates on hold for an extended period. The turmoil in financial markets has led to a general tightening of credit conditions, which has effectively done some of the ECB's work for it. Therefore, whereas we had previously expected interest rates to reach 4.5%, we now expect the peak to be at 4.25%.

Exchange Rates

Foreign exchange markets have been volatile over the past month – a pattern that is likely to be maintained until global credit markets find their feet. Sterling briefly touched a new multi-year high against the dollar at 2.06 and rose above 0.67 against the euro,

Exchange Rate Outlook

Source: Thomson Datastream/RBS Group Economics



before the credit market turbulence struck in late-July. But, as tighter financial conditions made further UK rate hikes appear increasingly unlikely, the pound lost ground, briefly falling back below the $2 level against the greenback and 0.68 against the single currency.

The sharpest moves were the result of "carry trades" being rapidly unwound. Carry trades occur where investors borrow money in countries with very low interest rates (like Japan) and invest the funds where interest rates are higher, taking the risk that adverse exchange rate moves wipe out their profits. As investors have become much more risk averse in recent weeks, so these trades have been unwound, leading to a sharp rise in low yielding currencies like the yen and falls in currencies like the Australian dollar and sterling (where interest rates are higher) as investors have rushed to repay the loans. The yen rose by almost 10% against sterling between mid-July and mid-August.

Foreign exchange rate forecasting, an inexact science at the best of times, is subject to even greater uncertainty given current fluid market conditions. That said, we expect sterling to lose a little more ground against the euro over the next twelve months as interest rate differentials are likely to narrow in the months ahead (Eurozone interest rates are more likely to rise than UK rates at this juncture). The relatively large UK trade deficit with the Eurozone further supports this view, where a weaker sterling exchange rate will help boost UK net exports and narrow the trade gap over time. The dollar may enjoy some short-term relief in the months ahead if we are correct and the three US interest rate cuts expected by investors before the end of the year fail to materialize. Nevertheless, ongoing concerns about the magnitude of the US current account deficit suggest that the dollar will weaken once again against the other major currencies towards the end of the forecast period.

RBS GROUP ECONOMICS INTEREST AND EXCHANGE RATE FORECASTS

	EXCHANGE RATES (End-of-Period)				INTEREST RATES (%, End-of-Period)		
	$ per £	$ per EUR	£ per EUR	$/JPY	Euro Refi Rate	US Funds Rate	UK Bank Rate
2006 Q1	1.73	1.21	0.70	118	2.50	4.75	4.50
Q2	1.85	1.28	0.69	114	2.75	5.25	4.50
Q3	1.87	1.27	0.68	118	3.00	5.25	4.75
Q4	1.96	1.32	0.67	119	3.50	5.25	5.00
2007 Q1	1.96	1.33	0.68	118	3.75	5.25	5.25
Q2	2.01	1.35	0.67	123	4.00	5.25	5.50
Q3	2.01	1.37	0.68	115	4.00	5.25	5.75
Q4	1.99	1.35	0.68	112	4.25	5.25	5.75
2008 Q1	1.91	1.32	0.69	112	4.25	5.25	5.75
Q2	1.91	1.34	0.70	110	4.25	5.25	5.75
Q3	1.94	1.38	0.71	105	4.25	5.25	5.50
Q4	1.94	1.40	0.72	105	4.25	5.25	5.50

Key Central Bank Monetary Policy Meeting Dates in 2007

Bank of England	6 September, 4 October, 8 November, 6 December
US Federal Reserve	18 September, 31 October, 11 December
European Central Bank	6 September, 4 October, 8 November, 6 December