Group Economics

Interest and Exchange Rate Forecast

16 September 2005

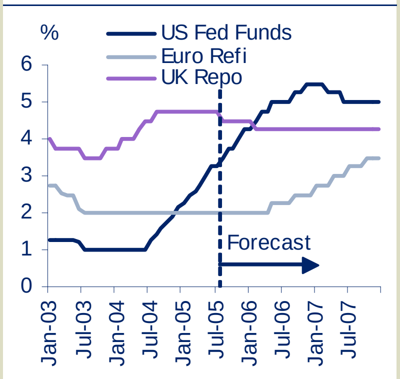
Contacts:
Robert Gardner
Group Economics
+44 131 626 3697
robert.a.gardner@rbs.co.uk

Stuart Green
Group Economics
+44 131 626 3696
stuart.green@rbs.co.uk

www.rbs.com/economics

Interest Rate Outlook

Source: Datastream/RBS Group Economics

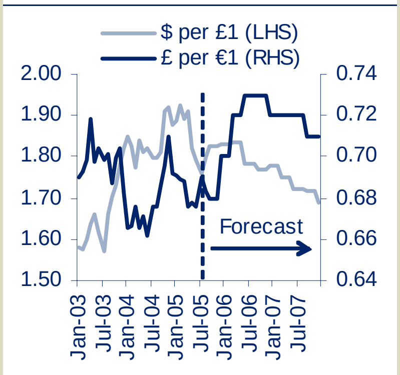


Want to keep on top of international developments?

Receive our weekly International Review (click here for request form)

Exchange Rate Forecast

Source: Datastream/RBS Group Economics



The pick-up in headline CPI inflation and some limited signs of strengthening activity appear to have moved the prospect of a further interest rate cut off the policy agenda in the UK for the time being. The apparent division with the MPC, together with the strikingly upbeat economic forecasts contained in the Bank of England's latest Inflation Report, had in any case already suggested that the August rate cut was highly unlikely to spark a series of further, near-term interest rate reductions. The Bank of England expects a more competitive pound, rising equity prices and the ongoing reduction in long-term interest rates to reignite the economy during the course of next year. But whilst we also look for growth to gain momentum, we expect a more modest upturn, and believe that a further interest rate cut will be required to support domestic demand and push the economy back towards its trend rate of expansion. We therefore look for the Bank of England to deliver one final rate cut in the current cycle early next year, placing the base rate at 4.25%.

We are optimistic that the impact of Hurricane Katrina on the US economy will prove to be predominantly temporary (click here to read more in-depth analysis). Lost output in the affected states and the dampening impact of higher energy prices on business and consumer spending is likely to keep growth in the 3% to 3.5% range in the latter half of this year. This is significantly lower than our pre-Katrina forecasts of 4.5%, but far from pushing the economy into recession and is unlikely to be sufficient to persuade the Fed to stop raising interest rates at it meeting on September 20th. (Especially since reconstruction activities are likely to provide a significant boost to economic growth next year, when the economy is already expected to be operating close to full capacity.) Indeed, policymakers will be keen to ensure that higher energy costs do not feed through to core inflation. The risks here are mounting. Labour market conditions have tightened (unemployment dipped below 5% in August) increasing the risk that elevated energy costs will pass through to wage claims. Moreover, productivity growth has started to slow, which will further curb the economy's capacity to grow without generating price pressures. We expect the Fed to hike rates by 25bps at the rest of its meetings this year, taking rates to 4.25% by end-2005. Further hikes are expected next year as the economy re-gains momentum, with the fed funds rate peaking at 5.5% in late 2006.

In the Eurozone, monetary policy continues to be subjected to a series of contrasting forces, but with no clear direction apparent, interest rates look set to remain on hold at 2% over the coming months. Some acceleration in regional GDP growth is expected following the meagre 0.3% Q2 gain, and German industrial production has surprised on the upside during recent months. Even so, business confidence generally remains under pressure, not least because of the rising oil price. Indeed, with the fledgling recovery seen as being at risk from higher energy costs, long-term interest rates have continued to decline, and the ECB remains concerned by the subsequent acceleration of credit/monetary growth. But, with the Eurozone seemingly certain to experience its fifth successive year of sub-trend growth, we expect interest rates to remain on hold for the remainder of 2005, before rising only very gradually to 2.5% by end-2006 and 3.5% by end-2007.

The dollar weakened sharply in the wake of hurricane Katrina as investors marked down their forecasts for US GDP growth and interest rates. The dollar briefly fell below 1.25 against the euro and 1.84 against sterling in early September. However, as evidence of the strength of the economy (pre-Katrina) emerged, along with more positive news about the clean-up operation, so the dollar re-traced most of its loses. We expect the dollar to remain close to current levels in the near term, especially against the euro, since short and long term interest rates remain significantly higher than their Eurozone counterparts. Interest rates are still higher in the UK, even after the August cut, but a further reduction by the Bank of England appears likely (though probably not until early next year). The Homeland Investment Act is also encouraging US firms to repatriate profits, providing additional support for the greenback. Nevertheless, the major currencies are expected to recover ground against the dollar in the latter part of 2005 and in 2006 as concerns over the US current account deficit resurface. The deficit reached a record $198 billion in Q1 2005, and is likely to widen further given the elevated level of oil prices, and more fundamentally, since US domestic demand growth continues to outpace that of its major trade partners.

GROUP ECONOMICS INTEREST AND EXCHANGE RATE FORECASTS

	EXCHANGE RATES (End-of-Period)				INTEREST RATES (Period Average)		
	£/$	EUR/$	EUR/£	$/JPY	Euro Refi Rate	US Funds Rate	UK Repo Rate
2004 Q1	1.84	1.23	0.67	104	2.0	1.0	3.9
Q2	1.81	1.22	0.67	109	2.0	1.1	4.3
Q3	1.81	1.24	0.69	110	2.0	1.5	4.7
Q4	1.92	1.36	0.71	102	2.0	2.0	4.8
2005 Q1	1.89	1.30	0.69	107	2.0	2.5	4.8
Q2	1.79	1.21	0.68	111	2.0	3.0	4.8
Q3	1.82	1.24	0.68	110	2.0	3.5	4.6
Q4	1.83	1.28	0.70	107	2.0	4.0	4.5
2006 Q1	1.83	1.32	0.72	105	2.0	4.5	4.3
Q2	1.78	1.30	0.73	104	2.2	4.9	4.3
Q3	1.77	1.29	0.73	103	2.3	5.1	4.3
Q4	1.78	1.28	0.72	98	2.5	5.4	4.3
2007 Q1	1.75	1.26	0.72	95	2.8	5.4	4.3
Q2	1.72	1.24	0.72	95	3.0	5.2	4.3
Q3	1.72	1.22	0.71	95	3.3	5.0	4.3
Q4	1.69	1.20	0.71	95	3.5	5.0	4.3