Group Economics

The Royal Bank of Scotland Group

Interest and Exchange Rate Forecast

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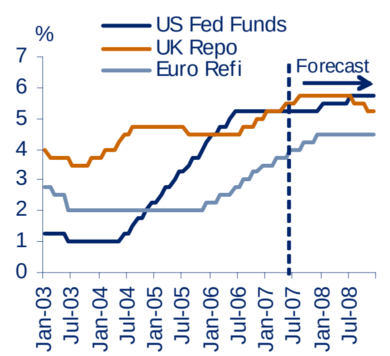
Interest Rates

The Monetary Policy Committee (MPC) voted to raise the Bank Rate at its May meeting, to 5.5%, the highest of all the G7 countries. The Committee cited the strength of the economy, rapid growth in borrowing and the money supply, and an apparent increase in companies' ability to push through price rises as reasons for the hike. Given the cautious tone struck in the minutes to the May meeting, where some members gave serious thought to a first ever half-point hike, we now expect another quarter-point increase in Q3. We have also shifted our forecast for two quarter-point rate cuts in Q1 and Q2 next year to Q3 and Q4 2008. As such, we do not anticipate any significant decline in swap rates over the remainder of 2007.

Interest Rate Forecast

Source: Thomson Datastream/RBS Group Economics

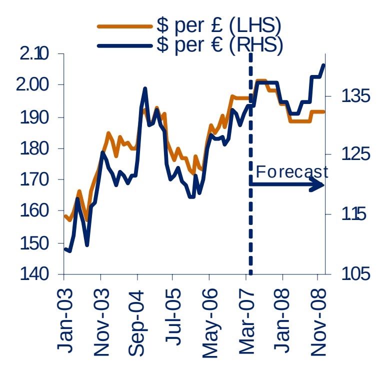


There appears to be little chance of an interest rate move in the United States in the near term. US policymakers will be heartened by signs that underlying price pressures appear to be moderating. The core CPI measure of US inflation fell to 2.3% in April, the lowest reading for twelve months, and back within the Fed's 1.5-2.5% comfort zone. However, this doesn't imply the need for near-term policy easing. We, like the Federal Reserve, continue to expect the economy to accelerate at the back end of 2007, as the drag from the residential construction sector fades and households adjust to higher energy costs. Moreover, it's by no means certain that inflation will remain subdued. Measures of resource utilisation suggest that there is still little slack in the economy, despite four consecutive quarters of sluggish economic growth. This is particularly clear in the labour market, where the unemployment rate is currently running at 4.5%, below the 5% level considered by most analysts to be "full employment". Further modest policy tightening is likely in 2008 in order to ensure price stability is maintained over the medium term.

Although Eurozone interest rates were kept on hold at 3.75% in May, another hike is likely soon. At the May press conference European Central Bank (ECB) President Trichet used the word 'strong vigilance', which is normally code for a rate increase at the next meeting. A move to 4% is therefore widely expected in June. Thereafter, the outlook is more uncertain. The continued strength of the recovery in the Eurozone suggests there is a good chance we will see further rate increases in the second half of the year. In Germany, business confidence measured by the Ifo survey is close to an all-time high and consumer confidence has also improved. Although mortgage credit growth has slowed in the Eurozone, corporate credit growth remains very strong. Policy makers and even some politicians have also expressed less concern about strength of the euro than they would have done with the exchange rate at similar levels in the past. We therefore now expect two more quarter-point rate increases by the ECB in the second half of 2007, taking rates to 4.5%.

Exchange Rate Outlook

Source: Thomson Datastream/RBS Group Economics



Exchange Rates

Sterling is likely to weaken a little against the euro. Our forecasts imply that investors are likely to mark down their expectations for UK interest rates in 2008, while revising up their projection for Eurozone rates. This suggests that sterling will moderate a little against the euro over the next two years. Moreover, Britain's large trade deficit is also likely to weigh on sterling's exchange rate with the single currency, given that the Eurozone is our largest trade partner. By contrast, if investors come around to our view that US interest rates are unlikely to fall any time soon, the pound and the euro are likely to lose some ground against the dollar in the latter half of 2007. These gains are likely to prove transitory and be capped by ongoing concerns about the size of the US trade deficit.

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	1.37	0.68	119	4.00	5.25	5.50
Q3	1.99	1.37	0.69	117	4.25	5.25	5.75
Q4	1.94	1.34	0.69	115	4.50	5.25	5.75
2008 Q1	1.89	1.32	0.70	112	4.50	5.50	5.75
Q2	1.89	1.34	0.71	110	4.50	5.50	5.75
Q3	1.92	1.38	0.72	105	4.50	5.75	5.50
Q4	1.92	1.40	0.73	105	4.50	5.75	5.25

Key Central Bank Monetary Policy Meeting Dates in 2007

Bank of England	7 June, 5 July, 2 August, 6 September, 4 October, 8 November, 6 December
US Federal Reserve	28 June, 7 August, 18 September, 31 October, 11 December
European Central Bank	6 June, 5 July, 2 August, 6 September, 4 October, 8 November, 6 December