

# Interest & Exchange Rate Outlook

## January 2008

Welcome to our latest bulletin which provides information only commentary on the issues affecting interest and exchange rates.

### Economic Background

The Monetary Policy Committee's (MPC) decision to leave interest rates unchanged at 5.5% in January came as no great surprise, as analysts had already been focusing on next month's meeting. Moves have always been seen as more likely in the months that coincide with the full quarterly assessment of the economic outlook which occurs ahead of the publication of the Inflation Report, the next of which is due in February.

Market sentiment about UK economic prospects has clearly deteriorated in recent weeks, but commentators will have to await the publication of the minutes of this month's meeting to gain a better understanding of how the MPC sees the balance of risk evolving. December's decision to cut interest rates by a quarter of a point was unanimous, with all nine members of the policy-making committee voting in favour of the move.

The minutes of the December MPC meeting noted that emerging news had suggested that "the short-run trade off between activity and inflation had worsened". Both the downside risks to activity from financial market turmoil and the inflation threat posed by the surge in oil prices and weakening of sterling were highlighted. Analysts will be keen to see whether the Bank of England concurs with the market view that the downside threat to activity was increasing, and whether any of the committee members voted for an immediate cut in rates.

Firm evidence that the wider economy is suffering under the weight of financial market problems and property market weakness is still patchy. Despite some poor trading updates from retailers, it remains too early to assess the resilience of the consumer over the crucial Christmas and New Year trading period. Survey evidence also points to some slowing of economic growth, but not the distress associated with declining output.

Members of the MPC are seeking to steer a course between the conflicting pressures presented by deteriorating output prospects and the threat of inflation

Period Averages	Base Rates	12-Month Interbank	3-Year Swap	5-Year Swap	Euro/£	Dollar/£
2004	4.39	4.9	5.1	5.2	1.47	1.83
2005	4.65	4.7	4.7	4.7	1.46	1.81
2006	4.64	5.0	5.1	5.0	1.47	1.84
2007	5.51	6.0	5.8	5.7	1.46	2.00
Q1 2007	5.22	5.7	5.6	5.5	1.49	1.95
Q2 2007	5.40	6.0	6.0	5.9	1.47	1.99
Q3 2007	5.74	6.3	6.1	6.0	1.47	2.02
Q4 2007	5.69	6.0	5.5	5.4	1.41	2.05
October 2007	5.75	6.1	5.7	5.6	1.44	2.04
November 2007	5.75	6.0	5.5	5.4	1.41	2.07
December 2007	5.54	5.9	5.3	5.2	1.39	2.02
Forecasts <sup>1</sup> :						
April 2008	5.00	5.1	4.8	4.8	1.31	1.95
July 2008	4.50	4.9	4.8	4.8	1.31	1.94
January 2009	4.50	4.7	4.8	4.8	1.31	1.93

<sup>1</sup>Based on market implied forward rates.  
Source: Bank of England, Thomson Datastream & Barclays Bank

expectations being dislodged by higher energy costs and a weaker exchange rate. Some slowing of the earlier, unsustainably rapid, pace of economic growth had always been seen as desirable. The question is whether this threatens to be unnecessarily sharp, going beyond that required to hold inflation to its target of 2%.

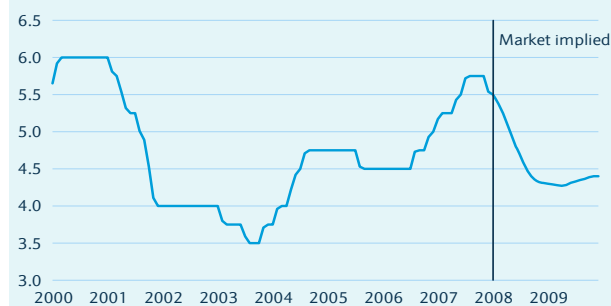
Consumer price inflation has risen to a fractionally-above-target rate of 2.1% and higher energy costs could add to inflation pressures in the coming months. But the policy framework is forward looking, so the question is whether the inflation target will be achieved over the medium term. An important consideration is whether higher living costs will be reflected in pay awards, leading to second-round effects on prices. Although there has been some evidence of an upward drift in the limited number of pay settlements agreed so far this winter, overall earnings growth remains well contained, with the regular element holding steady at less than 4%.

### Interest Rates

Expectations of lower interest rates have continued to build over the past month, but the futures market is pricing in falls that are larger than most analysts envisage. Term money rates have also fallen back towards the official Bank Rate as liquidity conditions eased following concerted action by central banks to alleviate money market pressures.

#### UK interest rates

##### Base rates, per cent



Source: Bank of England & Barclays Bank

The yield curve is now pricing-in at least a full percentage point reduction in rates over the course of this year, which would take base rates into the 4.25%-4.5% range. This reflects the perception that the downside risks to the UK economic outlook have increased, with equity markets suffering a broader sell-off. There are concerns that high street sales might be coming in weaker than expected – raising questions about the resilience of the UK consumer – while the international environment could prove less supportive as

Source of ONS data: National Statistics website: [www.statistics.gov.uk](http://www.statistics.gov.uk)  
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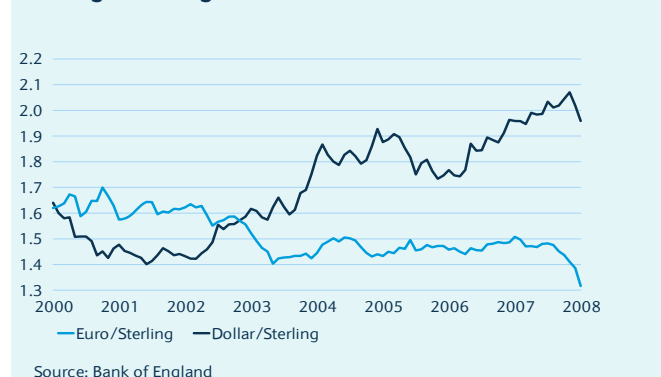
prospects for the US economy appear to be deteriorating.

Sentiment is liable to remain fluid and expectations are likely to be unusually sensitive to the latest 'headlines'. Much will depend, however, upon whether the slowdown suggested by surveys and trading updates is carried through into the more comprehensive 'official' demand and output data.

### Sterling

A sharp swing in UK interest rate expectations – from rising to appreciably lower base rates – has undermined the pound, which has weakened by 10% in overall exchange rate terms since late July 2007. It has fallen to a record low of 1.32 against the euro and has also given up some of its gains against the generally weak dollar, falling to 1.96 from a peak of over 2.10 in November.

#### Sterling exchange rates



Source: Bank of England

Reduced interest rate support for sterling and the dollar contracts with the position in the eurozone, where the European Central Bank (ECB) has reinforced its hawkish stance on interest rates with even tougher rhetoric. The ECB appears particularly concerned that higher wage settlements will fuel eurozone inflation pressures. Prospects for further cuts in US and UK interest rates have intensified, whereas the market believes that eurozone interest rates will be held at 4% for much of this year.

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