

# Interest & Exchange Rate Outlook

## April 2010

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

### Economic Background

Bank Rate remained at its historic low of 0.5% following this month's Monetary Policy Committee (MPC) meeting. The MPC also left the Bank's £200 billion quantitative easing (QE) programme on hold. Recent economic data indicate that the UK economy is continuing to recover from its longest and deepest post-War recession, but also suggest that underlying fragilities persist. With the MPC therefore widely perceived to be in 'wait and see' mode, both decisions were widely expected.

The latest official data show that GDP increased at a slightly faster rate of 0.4% during the final quarter of 2009, rather than 0.3% as previously estimated. Nevertheless, slower de-stocking was the main growth driver in the final months of 2009. Although consumer spending and government consumption also contributed positively to growth in the fourth quarter of 2009, net trade and/or investment will have to begin to make a positive contribution to growth for recovery to become

self-sustaining, given the constraints on government and household finances and the likely short-term nature of the boost to growth from re-stocking.

The pattern of growth in the first quarter of 2010 has been difficult to decipher due to a variety of distorting factors ranging from heavy snowfall to the reinstatement of the full rate of VAT. However, although the official industrial production and service sector data reveal that activity contracted at the beginning of 2010, the latest Purchasing Managers' Indices (PMIs) suggest that output has subsequently rebounded, with the manufacturing PMI recording a new 15-year high in March. Retail sales and house prices have also picked up once more.

Although still relatively high, unemployment has also edged down. However, a relatively high number of full-time job seekers remain in part-time work, while the number of economically inactive people in the UK is also high, largely reflecting rising student numbers. With fiscal tightening likely to result in public sector job cuts, the recovery will have to gain greater traction to prevent further growth in headline unemployment.

Period Averages	Base Rates	12-Month Interbank	3-Year Swap	5-Year Swap	Euro/£	Dollar/£
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
2008	4.68	5.6	5.0	5.0	1.26	1.85
2009	0.64	1.7	2.6	3.3	1.12	1.57
Q2 2009	0.50	1.9	2.7	3.3	1.14	1.55
Q3 2009	0.50	1.4	2.7	3.5	1.15	1.64
Q4 2009	0.50	1.2	2.5	3.2	1.11	1.63
Q1 2010	0.50	1.3	2.3	3.1	1.13	1.56
January 2010	0.50	1.3	2.5	3.2	1.13	1.62
February 2010	0.50	1.3	2.2	3.0	1.14	1.56
March 2010	0.50	1.3	2.2	2.9	1.11	1.51
Forecasts*:						
July 2010	0.50	1.4	2.4	3.1	1.13	1.54
October 2010	0.50	1.7	2.7	3.2	1.13	1.54
April 2011	1.00	2.2	3.1	3.6	1.13	1.54

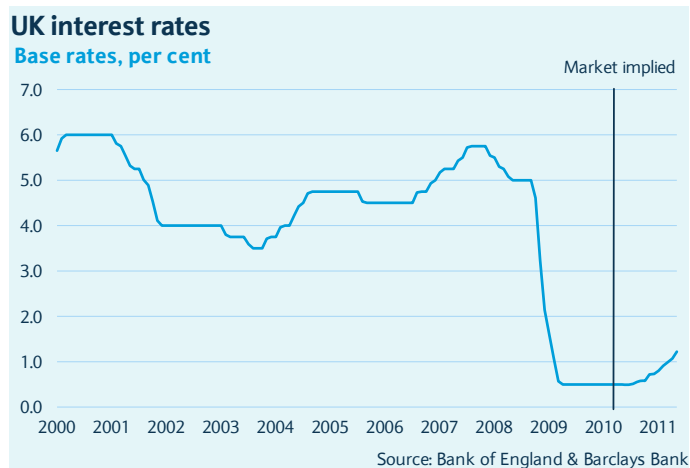
\*Based on market implied forward rates (source: Bank of England, Bloomberg & Barclays Bank).

As noted in the minutes of the previous MPC meeting, much will therefore depend upon the extent to which the lagged impact of previous fiscal and monetary policy loosening, as well as the 25% fall in sterling from its 2007 peak, can offset the negative impact of the considerable level of spare capacity in the economy, looming fiscal consolidation, household and financial sector de-leveraging and the prospect of relatively weak growth in the eurozone, the UK's main trading partner.

The Bank's central view is that the slack in the economy will bear down on inflation, pushing it back towards the 2% target rate in the second half of 2010 as the influence of the temporary factors behind the recent spike in inflation (such as higher VAT and oil prices and past sterling depreciation) begins to wane. Inflation is then likely to move below 2% for a period.

### Interest Rates

Although the MPC retains the option to re-start QE if the recovery falters, market participants remain focused on the likely timing and pace of monetary policy tightening. Market expectations have been pushed back considerably in recent months. However, while there is a broad range of opinions, the prevailing view in the markets is that Bank Rate is unlikely to rise before November, with monetary policy expected to remain supportive for some time thereafter.

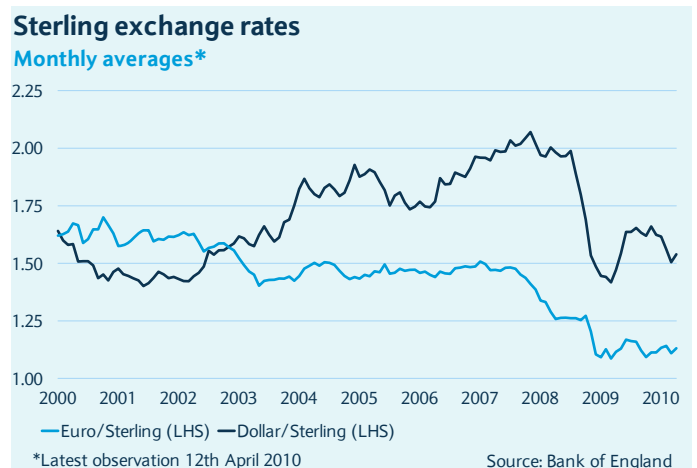


In the US, while the Federal Reserve is in the process of "normalising" its lending facilities, the Federal Open Markets Committee (FOMC) last month reiterated its view that economic conditions are "likely to warrant exceptionally low levels of the federal funds rate for an extended period." However, the minutes of its March meeting reveal that the FOMC believes that the term "extended period" refers to the evolution of economic data rather than calendar time. Markets expect the Fed to begin raising interest rates in November. The European

Central Bank (ECB) kept its main policy rate on hold at 1% again this month. Like the Fed, the ECB is unwinding its 'enhanced credit support' facilities as part of a policy 'normalisation' process, but markets currently expect eurozone rates to remain unchanged for the remainder of 2010.

### Exchange Rates

The euro fell to a 10-month low against the dollar during March amid continued concerns over the fiscal health of Greece and other 'peripheral' eurozone economies. An emergency eurozone/IMF assistance package has been agreed to provide support for Greece and the ECB has deferred the planned reinstatement of its pre-recession collateral requirements (which some feared may have ultimately excluded Greek bonds). However, uncertainty over the conditions that would be attached to the former and the new system of graduated haircuts for higher risk assets applied to the latter have caused unease. In addition to concerns that eurozone GDP growth is faltering and that, as a result, monetary policy will be tightened much more slowly than in the US, last month's decision by Fitch to downgrade its Portuguese sovereign rating also eroded support for the euro.



While sterling has pulled back from last month's lows against both the euro and the dollar, the lack of clarity over longer term fiscal consolidation in last month's Budget and concerns over the prospect of a hung parliament (and resultant delays in formulating a medium-term fiscal consolidation strategy) following next month's General Election continue to weigh on the pound.

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