

Interest & Exchange Rate Outlook

February 2010

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

Economic Background

The Monetary Policy Committee (MPC) left Bank Rate unchanged at its historic low of 0.5% following its recent meeting. The MPC also decided not to extend the £200 billion limit on the stock of assets financed by the issuance of central bank reserves via the Bank's Asset Purchase Facility (APF)¹. Asset purchases had already reached this limit at the time of the announcement. The decision therefore brought the Bank's quantitative easing (QE) policy to a halt, although the MPC retains the option of resuming QE, should the nascent UK recovery falter.

Both decisions were widely expected, although disappointing GDP data for the fourth quarter of 2009 and a sharp jump in CPI inflation had given observers some pause for thought leading up to the announcement. The data showed that, although the UK economy emerged from recession in the final quarter of 2009 (at least in a technical sense), growth resumed at a

far slower rate (0.1%) than had been expected. At the same time, data for December showed that CPI inflation had accelerated to 2.9% from 1.9% in November.

In a statement announcing the MPC's decision, the Bank voiced cautious optimism that, following the "sluggish" growth recorded at the end of 2009, the economy will experience a "gradual recovery". Although the Bank expects the considerable stimulus from monetary policy easing and the lower level of sterling to support both domestic and export market activity, it expects credit conditions to remain "restrictive," with fiscal tightening and de-leveraging in the private sector likely to dampen growth further.

The Bank also acknowledged that CPI inflation had risen "sharply," with the restoration of the full rate of VAT from January 2010 likely to see it rise further above the 2% target rate in the near term. However, pay growth remains subdued and, although the recession has "probably impaired the supply capacity of the economy ... the scale and persistence of the fall in output means that a substantial margin of under-utilised resources is likely to remain for some time to come." As a result, the

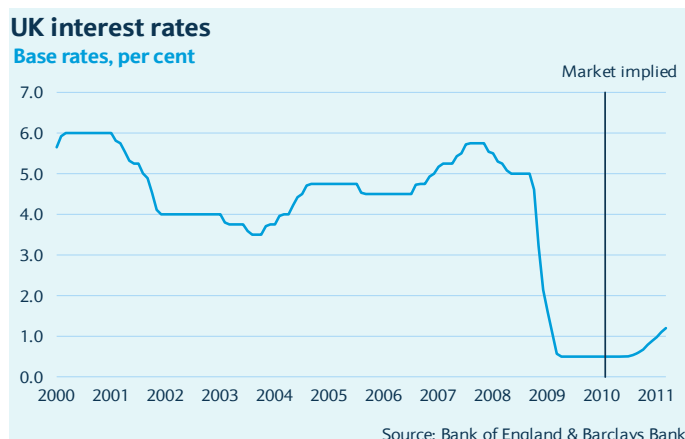
Period Averages	Base Rates	12-Month Interbank	3-Year Swap	5-Year Swap	Euro/£	Dollar/£
2006	4.64	5.0	5.1	5.0	1.47	1.84
2007	5.51	6.0	5.8	5.7	1.46	2.00
2008	4.68	5.6	5.0	5.0	1.26	1.85
2009	0.64	1.7	2.6	3.3	1.12	1.57
Q1 2009	1.07	2.4	2.5	3.0	1.10	1.43
Q2 2009	0.50	1.9	2.7	3.3	1.14	1.55
Q3 2009	0.50	1.4	2.7	3.5	1.15	1.64
Q4 2009	0.50	1.2	2.5	3.2	1.11	1.63
November 2009	0.50	1.2	2.5	3.2	1.11	1.66
December 2009	0.50	1.3	2.5	3.2	1.11	1.62
January 2010	0.50	1.3	2.5	3.2	1.13	1.62
Forecasts*:						
May 2010	0.50	1.4	2.5	3.2	1.14	1.56
August 2010	0.50	1.8	2.7	3.2	1.14	1.56
February 2011	1.00	2.3	3.2	3.6	1.14	1.56

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

recent rise in inflation is likely to prove temporary. Indeed, the Bank believes that inflation will fall back below the target rate for a period. A clearer view of the Bank's inflation expectations will be available when it publishes its Inflation Report later this week.

Interest Rates

The MPC has left the door ajar for a resumption of QE in the event that the forecast acceleration in activity does not materialise in the first half of 2010. However, although such a course of action cannot be completely ruled out, further QE seems unlikely. As a result, attention is now focused on when, and how quickly, base rates will rise.



Market expectations have been pushed back considerably over the past month, reflecting concerns over the apparent lack of momentum in the UK recovery. The prevailing view in the markets is that a rate rise is unlikely before October, with monetary policy expected to remain accommodative for some time thereafter.

Following its meeting at the end of January, the Federal Open Market Committee (FOMC) restated its view that, although the US economy continues to strengthen, conditions “are likely to warrant exceptionally low levels of the federal funds rate for an extended period.” However, the Federal Reserve is also in the process of unwinding its unconventional policy measures. Officials reaffirmed the closure of most of the Federal Reserve's special liquidity facilities on 1st February 2010 and announced the expiry of temporary liquidity swap arrangements with other central banks on the same date, as well as plans to wind down the Term Auction Facility (the last auction is scheduled to take place on 8th March).

The European Central Bank (ECB) kept its main policy rate on hold at 1% again this month, with markets currently forecasting that it will remain unchanged for the

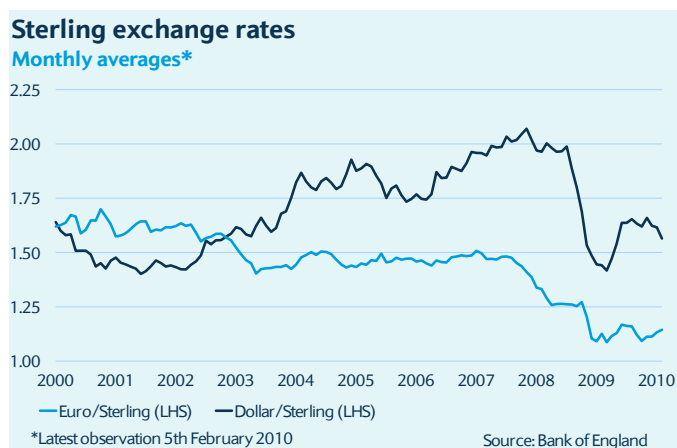
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remainder of 2010. However, the ECB is also in the process of unwinding its programme of ‘enhanced credit support.’

Exchange Rates

While concerns persist over the outlook for US public finances (ratings agency Moody's, for example, recently posted a warning about the long term sustainability of the country's ‘AAA’ sovereign rating), the fiscal challenges facing Greece, Spain, Portugal and, to a lesser degree, Ireland appear to be of more immediate concern to market participants. These concerns continue to erode support for the euro, which has fallen to its lowest level against the US dollar since May 2009. At the same time, growing ‘safe haven’ demand for US dollars has propelled the greenback to a seven-month high on a trade-weighted basis during the past week.



Concerns over the fiscal health of the eurozone's peripheral states has offset continued anxiety over the UK's public finances, in terms of the euro:sterling exchange rate. At the end of last week, the pound was 1.7% higher against the single currency than at the beginning of January. However, sterling has lost further ground against the US dollar, with a marked decline during the first week of February pushing the pound to an eight-month low against the greenback.

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¹ The Bank of England will continue to purchase high-quality private sector assets via the APF. However, future purchases will be financed by the issue of Treasury bills, in line with the arrangements announced on 29th January 2009, rather than the creation of new reserve funds.