

# Interest & Exchange Rate Outlook

## March 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 once again at its recent meeting. As a result, the policy rate has now been maintained at an historic low of 0.5% for 12 months. The MPC also voted 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), leaving quantitative easing (QE) on hold for a second successive month. Both decisions were widely expected.

The emerging data continue to paint a mixed picture of the strength of recovery in the UK. GDP is now estimated to have increased by 0.3% during the final quarter of 2009, rather than 0.1%, as the preliminary data suggested. The upward revision brings the official data more into line with estimates of activity based on Purchasing Managers' Indices (PMIs), which suggest that growth has carried over into 2010. Having dipped in

January, when activity was adversely affected by heavy snowfall, the service sector PMI surged to a three-year high in February, while the manufacturing PMI remained at January's 15-year peak. Signs of stability in the labour market provided further grounds for cautious optimism, while the Bank will also have been encouraged by the return to growth of the 'non-financial sector' M4 money supply, one of the yardsticks by which it measures the effectiveness of its quantitative easing policy.

However, the underlying fragility of the nascent recovery was also evident in much of the recent data. While consumer demand made a positive contribution to GDP growth in the final quarter of 2009, slower de-stocking provided the main thrust. Net trade and investment had a negative influence on growth, but with stock-building likely to provide only short-term support, other demand drivers will have to pick up if recovery is to become self-sustaining, especially as government consumption (which also contributed positively to GDP growth in the fourth quarter) is set to slow as fiscal policy is tightened.

In addition, although affected by adverse weather conditions and the reversion to the lower stamp duty

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
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
February 2010	0.50	1.3	2.2	3.0	1.14	1.56
Forecasts*:						
June 2010	0.50	1.5	2.5	3.1	1.11	1.51
September 2010	0.50	1.8	2.7	3.2	1.11	1.51
March 2011	1.25	2.3	3.1	3.6	1.11	1.51

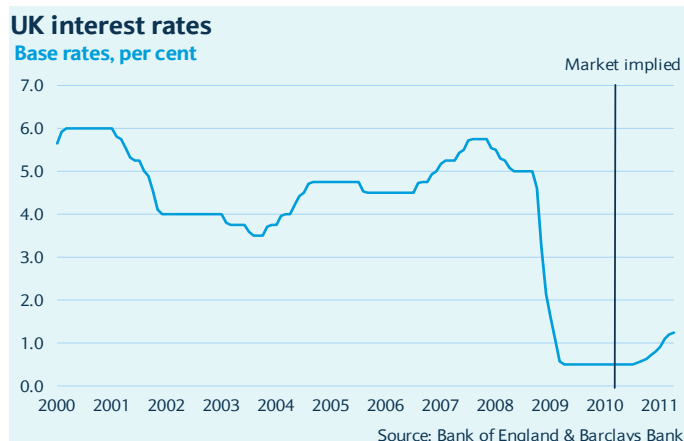
\*Based on market implied forward rates (source: Bank of England, Bloomberg & Barclays Bank).

threshold on 1st January, recent data pointed to renewed weakness in the housing market. Retail sales also weakened in January, although the severe weather and the re-instatement of the full rate of VAT will have influenced the data, with the latest CBI survey suggesting an improvement in February. Weak fourth quarter growth in the eurozone, the UK's main trading partner, also raised concerns over the durability of recovery in mainland Europe and, as a result, the outlook for UK export demand.

Consumer price inflation jumped to 3.5% in January, prompting the Governor of the Bank of England to send a letter of explanation to the Chancellor. This stated that the recent rise in inflation was due to temporary factors, including the restoration of the full rate of VAT, higher oil prices and past sterling depreciation. While it is likely to remain elevated in the near term, the Bank's latest forecasts suggest that the considerable spare capacity in the economy, allied to tight credit conditions and de-leveraging in both the private and public sector, will bear down on inflation, pushing it back towards the 2% target rate in the second half of 2010. It is then "more likely than not to move below the 2% target for a period."

### Interest Rates

Although Bank officials have stated that QE could be re-started if the recovery falters, attention is now focused on the likely timing and pace of monetary policy tightening. Market expectations have been pushed back considerably in recent months and, while there is a 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.



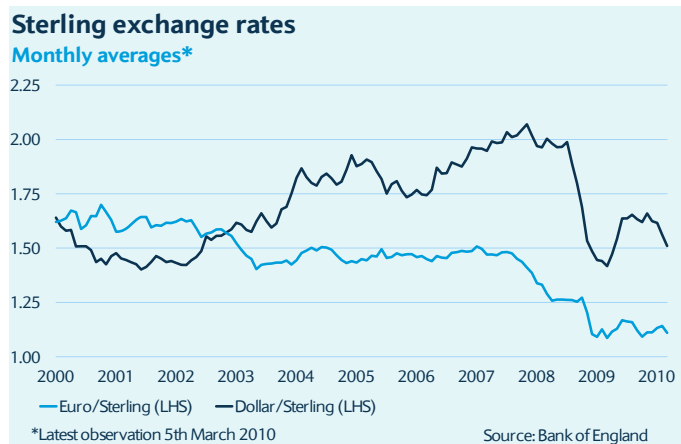
In the US, the Federal Reserve has closed, or is in the process of winding down, most of its special liquidity facilities. The Fed also raised the discount rate by 25bps last month to 0.75%. However, officials have stressed that these changes are part of the "normalization" of the Fed's

lending facilities, rather than a sign of imminent monetary policy tightening, with economic conditions "likely to warrant exceptionally low levels of the federal funds rate for an extended period." Markets do not currently expect any increase in the US policy rate until November.

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 remainder of 2010. Like the Fed, the ECB is in the process of unwinding its programme of 'enhanced credit support.' However, it has also stressed that this is part of a 'normalisation' process, rather than a change in the monetary policy stance.

### Exchange Rates

The euro has fallen to a nine-month low against the dollar as concerns over the fiscal health of Greece and other peripheral eurozone economies continue to weigh on the single currency. Faltering GDP growth and expectations of more gradual monetary policy tightening in the eurozone than in the US have also eroded support for the euro.



Concerns over the UK's public finances saw sterling slip to a 10-month low against the dollar and a four month low against the euro last week. Recent opinion polls have suggested that there is an increased likelihood of a hung parliament following the forthcoming General Election, which is expected to take place in May. This, it is feared, would impede fiscal tightening. The proposed US\$35 billion purchase of AIG's Asian arm by Prudential also contributed to sterling's decline last week.

Prepared: 8<sup>th</sup> March 2010

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