

Interest & Exchange Rate Outlook

May 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 0.5% following its recent meeting (which was delayed due to the previous week's General Election). The MPC also left the Bank's £200 billion quantitative easing (QE) programme on hold.

Despite a renewed rise in inflation to an above-target 3.4% in March, both decisions were widely expected, with the UK still in the early stages of recovery from its worst post-war recession. According to preliminary estimates, UK GDP increased by just 0.2% in the first quarter of 2010. Although adverse weather conditions and the impact of 'one-off' factors (such as the re-introduction of the full rate of VAT) had been expected to constrain first quarter growth, the data nevertheless fell short of the 0.4% growth rate that most observers had expected. However, continued growth did at least help to allay fears of a double-dip recession and, given previous revisions to preliminary data, an upward

revision would not be surprising, especially considering the relatively robust Purchasing Managers' Index readings recorded for both the services and manufacturing sectors during the first quarter.

Nevertheless, other data continue to highlight the fragility of the recovery. Although there is evidence that the pick-up in private sector recruitment is gaining momentum, unemployment continues to drift upwards and is likely to remain relatively high in the short-medium term, with plans to accelerate fiscal tightening likely to result in public sector job losses. Housing market activity, while still broadly improving, has also shown signs of easing once more in recent months. However, the restoration of the lower stamp duty threshold and other distortionary factors have made it difficult to gauge the strength of the housing market in recent months.

While sectors such as manufacturing appear to be benefiting from improved export demand, UK trade data still offer few signs of an economy-wide shift towards more balanced UK growth, based on a higher net trade contribution. Weak growth in the eurozone (the UK's main trading partner) continues to offset the positive impact of sterling depreciation on the UK's export

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
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
April 2010	0.50	1.3	2.2	2.9	1.14	1.53
Forecasts*:						
July 2010	0.50	1.5	2.1	2.9	1.17	1.44
October 2010	0.50	1.6	2.3	2.9	1.17	1.44
April 2011	0.75	1.8	2.7	3.2	1.17	1.44

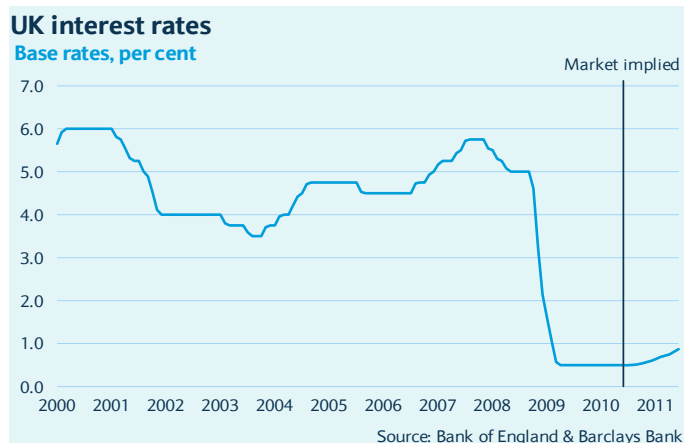
*Based on market implied forward rates (source: Bank of England, Bloomberg & Barclays Bank).

competitiveness, with fiscal pressures likely to continue to adversely affect not only eurozone demand, but also financial sector balance sheets and private sector confidence. In its recent Inflation Report, the Bank highlighted this as a key downside risk for UK GDP growth.

Whilst acknowledging the upside risks of above-target inflation in the near term (and the possibility that this might stoke inflation expectations) and further potential increases in commodity prices, the Bank maintains its central view that the considerable degree of slack in the economy and accelerated fiscal consolidation will bear down on inflation. This is expected to push it back towards the 2% target rate by the end of 2010, as the influence of the temporary factors behind the recent spike in inflation (such as higher VAT) wanes. The Bank's forecasts suggest that inflation will then fall below 2% for a period.

Interest Rates

Although there are signs that recovery is beginning to gain traction in the UK, recent market volatility resulting from events in Greece and the wider eurozone, the uncertain outlook for the UK economy and the prospect of more rapid fiscal consolidation have pushed back considerably market expectations of the likely timing and pace of UK monetary policy tightening. Bank Rate is currently expected to remain at 0.5% until spring 2011 and to remain accommodative for a prolonged period thereafter.



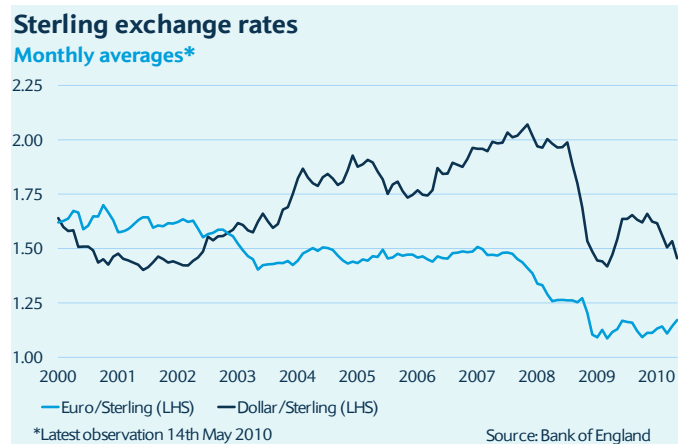
In the US, while the Federal Open Markets Committee (FOMC) noted in its April statement that “economic activity has continued to strengthen and that the labor market is stabilizing,” it maintained its previous view that economic conditions are “likely to warrant exceptionally low levels of the federal funds rate for an extended period.” The consensus view in the market is that US interest rates will be left on hold until November.

The European Central Bank (ECB) kept its main policy rate on hold at 1% again this month. However, in light of

continued market turbulence, the ECB has re-activated longer-term bank liquidity facilities and dollar swap lines, and established a Securities Market Programme to purchase public and private debt securities. While they do not constitute a further loosening of eurozone monetary policy *per se*, these measures (and concerns over the outlook for the eurozone) suggest that ECB interest rates will remain on hold for some time to come.

Exchange Rates

The euro has fallen to a 4-year low against the US dollar. Despite the provision of an enhanced financial support package for Greece, the creation of a wider €750 billion joint EU/IMF funding mechanism to support eurozone economies facing financial difficulties, intervention in the bond markets by the ECB and the announcement of accelerated fiscal tightening in Greece, Portugal and Spain, concerns persist over the fiscal position of the eurozone's peripheral countries, which have suffered further credit ratings downgrades in recent weeks. Investors have also been mulling the potentially deflationary impact of medium term fiscal tightening across the eurozone.



Although events in the eurozone have seen sterling strengthen against the single currency, fiscal concerns continue to weigh on the pound. The recent General Election produced a hung parliament, which saw sterling weaken further against the dollar, amid fears that this would delay fiscal tightening. The new coalition government's plans to accelerate fiscal tightening have provided the markets with a degree of reassurance in this respect, but this is widely expected to delay monetary policy tightening, which will dampen sterling demand.

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