

# Interest & Exchange Rate Outlook

June 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 the June meeting of the Monetary Policy Committee (MPC). The MPC also left the Bank's £200 billion quantitative easing (QE) programme on hold. Despite a further rise in consumer price inflation to 3.7% in April (significantly above the Bank's 2% target rate), both decisions were widely expected.

The latest data suggest that, while the UK's gradual recovery remains broadly on track, the economy continues to face considerable headwinds. As expected, first quarter GDP growth was revised upwards to 0.3%, from a preliminary reading of 0.2%. Despite the revision, growth remains below both the long run trend rate (0.6%) and the growth rate recorded for the previous quarter (0.4%), although adverse weather conditions and the impact of 'one-off' factors, such as the re-introduction of the full rate of VAT, clearly constrained first quarter growth.

A breakdown of the data reveals that a bounce in

business investment, slower de-stocking and continued growth in government consumption were the key drivers of first quarter growth, offsetting flat consumer spending and a negative net trade contribution. Industrial production growth was robust, although growth in service sector activity slowed.

Purchasing Managers' Index (PMI) readings for both the services and manufacturing sectors suggest that output growth has continued in the near term. However, other data continue to highlight the fragility of the recovery. Housing market data, while still broadly positive, have been mixed in recent months and, although private sector employment prospects are improving, unemployment has drifted up to 2.5 million (or 8% of the workforce) and is likely to remain relatively high in the short-medium term, with planned fiscal tightening expected to result in public sector job losses. Wage growth also remains weak and, in contrast to 2009, high inflation is weakening growth in real personal disposable income, which is likely to be further squeezed by higher taxes as fiscal policy is tightened.

The sovereign debt crisis in Europe is a further significant concern for the Bank. According to the minutes of the MPC's May meeting, members' noted that developments in the eurozone could have a negative impact on the UK

| 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     |
| 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     |
| May 2010        | 0.50       | 1.4                | 2.0         | 2.7         | 1.17   | 1.46     |
| Forecasts*:     |            |                    |             |             |        |          |
| August 2010     | 0.50       | 1.5                | 2.1         | 2.7         | 1.20   | 1.48     |
| November 2010   | 0.50       | 1.7                | 2.2         | 2.7         | 1.20   | 1.48     |
| May 2011        | 0.75       | 1.8                | 2.5         | 3.0         | 1.20   | 1.48     |

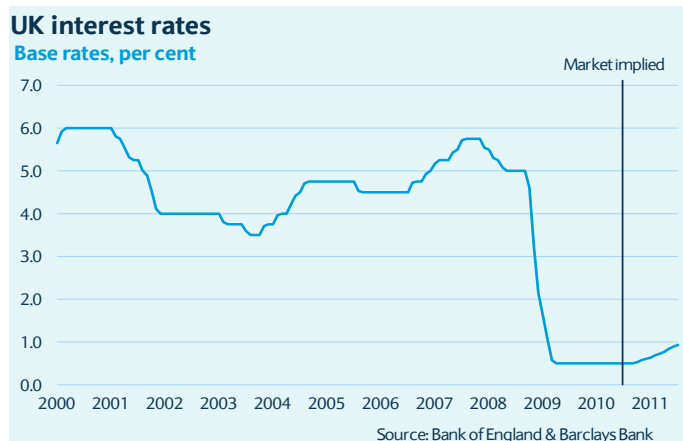
\*Based on market implied forward rates (source: Bank of England, Bloomberg & Barclays Bank).

economy in several different ways: by dampening growth and thus reducing demand for UK exports; by denting private sector confidence in the UK; by slowing the pace of credit easing in the UK; and by increasing UK public debt servicing costs if financial market concerns about deficit reduction spread beyond the eurozone periphery. Even if support measures prove successful, accelerated fiscal reduction in the eurozone is still likely to impact on growth and demand for UK goods and services.

As a result, whilst acknowledging the upside risks of above-target inflation in the near term (and the possibility that this might stoke inflation expectations), the Bank maintains its central view that the recent spike in inflation has been driven largely by temporary factors, such as higher VAT, and that spare capacity in the economy and accelerated fiscal consolidation (which it has endorsed) will push it below 2% in the medium term.

### Interest Rates

The more aggressive fiscal tightening planned by the UK's new coalition government, allied to the eurozone sovereign debt crisis (and resultant concerns over the wider economic recovery) have pushed back significantly 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 testimony to the US House of Representatives Budget Committee, Federal Reserve Chairman Ben Bernanke noted that the US recovery had “continued at a moderate pace so far this year.” While the Fed expects the pace of recovery to pick up in the coming year, “significant restraints on the pace of the recovery remain,” in terms of the underlying weakness of the US property market and the slow recovery expected in the labour market. The consensus view in the market is, therefore, that US interest rates will be left on hold until the first quarter of 2011.

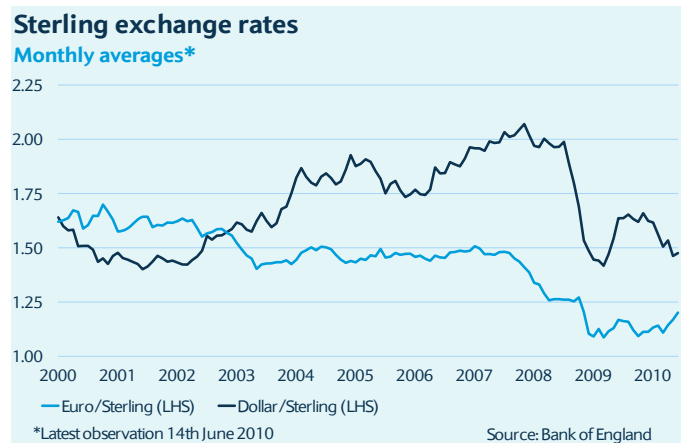
Source of ONS data: National Statistics website: [www.statistics.gov.uk](http://www.statistics.gov.uk)  
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As expected, the European Central Bank (ECB) kept its main policy rate on hold at 1% again this month. It also revealed that the value of assets purchased via its new Securities Market Programme had risen to €40.5 billion. The on-going sovereign debt crisis and its impact on the financial sector, and the creation of the asset purchase programme and re-introduction of enhanced liquidity facilities to mitigate it, suggest that ECB interest rates will remain on hold for some time to come.

### Exchange Rates

The euro has fallen to fresh four-year lows against the US dollar during the past month. Sovereign debt concerns continue to undermine the euro, despite the provision of financial support for Greece, the establishment of a wider €750 billion joint EU/IMF funding mechanism to support eurozone economies facing financial difficulties, intervention by the ECB to backstop the eurozone bond market and accelerated fiscal tightening in the eurozone's periphery economies. Investors also remain mindful of the potentially deflationary impact of aggressive medium term fiscal tightening across much of the eurozone. In contrast, the dollar continues to benefit from 'safe haven' flows.



Events in the eurozone have seen sterling continue to strengthen against the single currency over the past month, lifting the pound above €1.20 for the first time since November 2008. The determination of the UK's new coalition government to push ahead with a faster and more aggressive fiscal tightening programme than its predecessor has also provided support for sterling.

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