Interest & Exchange Rate Outlook

June 2009

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) of the Bank of England left Bank Rate unchanged at 0.5% and voted to continue with its £125 billion programme of asset purchases financed by the issuance of central bank reserves at its recent meeting.

With a change in base rates effectively precluded by the Bank's on-going quantitative easing programme, the MPC's decision on Bank Rate was widely anticipated. Similarly, having increased the limit on its quantitative easing programme to £125 billion (from an initial cap of £75 billion) in May, few observers expected any further changes this month.

In its recent Inflation Report, the Bank noted that, although the UK and many of the other major global economies are still deep in recession, there have been signs that the pace of decline has begun to moderate.

In the UK, the latest reading of the Purchasing Managers' Index (PMI) for the services sector suggests that activity has begun to pick up once more. Also, while continuing to indicate contraction, recent PMI readings for the manufacturing and construction industries suggest that the pace of decline has eased somewhat. Similar signs of improvement have also been evident overseas.

At the same time, while it remains very weak from a longer term perspective, the recent pick up in mortgage approvals, buyer inquiries and other leading indicators suggests that activity in the UK housing market is slowly beginning to pull back from the low levels recorded at the turn of the year, although first-time buyers continue to face difficulties in terms of raising deposits. Consumer confidence, although still weak, has also improved in recent months, as monetary and fiscal loosening has helped ease pressures on household budgets.

There have also been further signs of improved confidence and risk appetite in financial markets. Credit risks spreads have narrowed further, while equity markets (particularly in higher risk emerging markets) have continued to recover from their March lows.

Period Averages	Base Rates	12-Month Interbank	3-Year Swap	5-Year Swap	Euro/£	Dollar/£
2005	4.65	4.7	4.7	4.7	1.46	1.81
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
Q2 2008	5.03	6.0	5.6	5.5	1.26	1.97
Q3 2008	5.00	6.1	5.5	5.5	1.26	1.89
Q4 2008	3.37	4.8	3.8	4.1	1.20	1.57
Q1 2009	1.07	2.4	2.5	3.0	1.10	1.43
March 2009	0.57	2.2	2.5	3.0	1.09	1.42
April 2009	0.50	2.0	2.6	3.2	1.12	1.47
May 2009	0.50	1.9	2.5	3.2	1.13	1.54
Forecasts[1]:						
September 2009	0.50	1.9	3.0	3.7	1.15	1.60
December 2009	0.75	2.1	3.2	3.7	1.15	1.60
June 2010	1.75	2.6	3.7	4.0	1.15	1.60

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

Nevertheless, concerns persist about the sustainability of the nascent recovery in the face of rising unemployment and continuing balance sheet restructuring in the banking sector, as well as corporate and household deleveraging. Although the MPC believes that GDP growth will recover, as these forces are increasingly offset by the "considerable economic stimulus" from the significant easing in monetary and fiscal policy and policies to improve credit availability (both in the UK and overseas), as well as sterling depreciation and past falls in commodity prices, "the timing and strength of that recovery is highly uncertain."

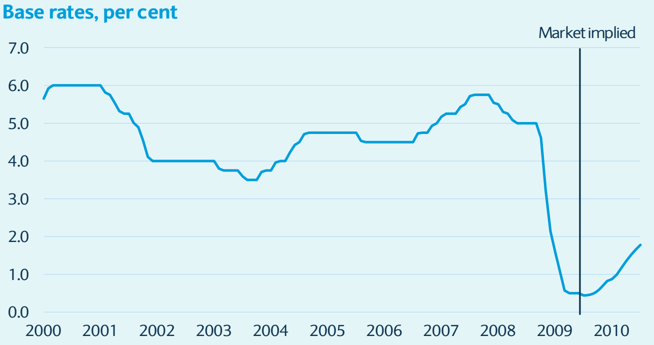
The outlook for inflation is also subject to countervailing forces. However, the Bank believes that further labour market loosening and increased spare capacity in the economy are likely to outweigh upward pressure on inflation from sterling weakness. As a result, "it is more likely than not that CPI inflation will be below the 2% inflation target in the medium term."

Interest Rates

With UK interest rates having effectively reached a floor, attention will remain focused on the Bank's quantitative easing programme in the near term. The Bank's inflation forecasts, and the fact that the MPC considered the possibility of a larger increase in its asset purchase programme in May, suggest that some further easing may be required. This may, in turn, require an extension of the current £150 billion upper limit agreed with the Treasury. However, while the debate has begun to shift towards the pace and durability of recovery, interest rates are likely to remain on hold until at least the end of 2009.

UK interest rates

Base rates, per cent



Source: Bank of England & Barclays Bank

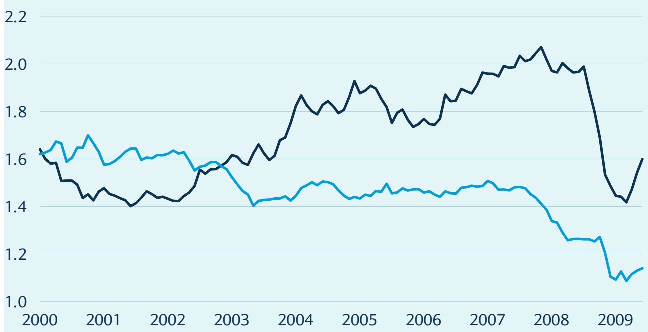
In the US, interest rates have remained unchanged since the Federal Reserve cut its main policy rate to a range of 0%-0.25% in December. With the policy rate effectively zero-bound, the Fed is expected to keep the policy rate on hold and to continue its wide-ranging programme of credit and quantitative easing measures, which has seen the Federal Reserve balance sheet more than double since September 2008 to over US$2 trillion.

As expected, the European Central Bank (ECB) kept its main policy rate on hold at 1% this month, which markets increasingly believe marks the effective floor for eurozone interest rates. The bank also provided more detail on its 60 billion euro covered bond purchase programme (announced last month), under which it will purchase securities from across the eurozone in both the primary and secondary markets between July 2009 and June 2010.

Exchange Rates

Although it remained below the peak rate recorded in July 2008, further tentative signs that the global recession may be abating and the resultant improvement in confidence and risk appetite, allied to concerns over the projected deterioration in US pubic finances, saw the euro strengthen by a further 3.5% against the US dollar in May.

Sterling exchange rates



—Euro/Sterling —Dollar/Sterling

Source: Bank of England

Sterling's recovery from a 23-year low against the greenback, and near parity with the euro, at the beginning of the year also continued in May. However, political uncertainties have subsequently seen the pound retreat from its recent seven month high against the US dollar and, despite appreciating in recent months, it is still almost 25% below its July 2007 peak on a trade-weighted basis.

Prepared: 8th June 2009

Source of ONS data: National Statistics website: www.statistics.gov.uk