Group Economics

Global Economic Outlook

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Contacts:
Robert Gardner
Group Economics
+44 131 626 3697
robert.a.gardner@rbs.co.uk

Robert Blotevogel (**UK/CEER**)
Group Economics
+44 131 626 3953
robert.blotevogel@rbs.co.uk

Gareth Claase (**US**)
Group Economics
+44 131 626 3873
gareth.claase@rbs.co.uk

David Rea (**EZ/Asia**)
Group Economics
+44 131 626 3889
david.a.rea@rbs.co.uk

GDP Growth Forecasts (%)

	2008	2009	2010	2011
UK	0.7	-4.0	-0.7	1.6
US	1.1	-3.2	0.6	2.2
Euro area	0.9	-3.3	-0.7	0.6
Japan	-0.7	-6.3	0.3	1.0
China	8.7	5.0	7.5	8.0

Source: RBS Group Economics

Fire and Ice

Economic activity has fallen off a cliff, and the bottom is not yet in sight. No region has managed to escape unscathed. Economies with high debt levels - UK, US, Ireland, Spain, and much of Central Europe among them - are struggling to repair balance sheets in the wake of the financial crisis. A trade slump has dealt a blow to export-dependant countries - from Germany in the West, to Japan and emerging Asia in the East. Collapsing raw material prices are hitting commodity producers across the Americas, Middle East and Africa.

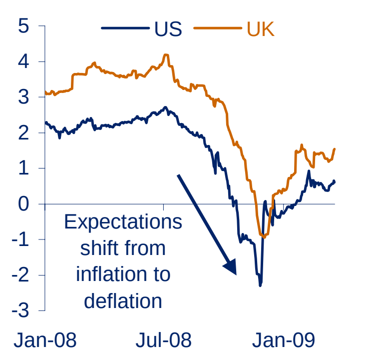
A few economies are still growing - India, China, isolated parts of Latin America and Africa. But even there it feels like a recession, as the pace of activity is far below the fevered rate of recent years. Understandably, growth prospects are the primary concern at present, but inflation risks should not be overlooked. **In the near-term, deflation threatens to turn recession into depression, while further out lurks the spectre of inflation.**

The only thing worse than rising prices is falling prices

Across the global economy, spare capacity is building at an alarming pace. Industrial output has slumped to levels last seen in the early 1990s in the UK and to 1980s levels in Japan. The percentage of idle plant and machinery in the US manufacturing sector is the highest since data collection began in 1967. As the gulf between what economies can produce and what is being demanded grows, firms are slashing prices to try to entice buyers.

The risk is that we descend into a deflationary spiral (chart 1). Falling prices lead people to postpone purchases (as they expect prices to be even lower in future). Debts, already too high in many economies, become harder to service and act as a further drag. Firms' efforts to cut costs lead to lower wages taking much needed purchasing power out of the economy.

Chart 1: Deflation risks are growing
(5-year inflation expectations – difference between yields on index-linked and non-indexed government bonds; in %)
Source: Thomson Datastream



Inflation - dead or dozing?

Policymakers are pulling out all the stops. Fiscal policy, ultra-low interest rates and unorthodox measures, like "quantitative easing", are all being brought to the fight. But there is a risk that these measures lead to surging inflation further out. Many policies are untested. A mistake, e.g. leaving policy too supportive for too long, would be easy to make.

Judging how fast economies can grow before generating inflation will also be tricky. Trend growth rates are likely to be lower than we've been used to, as the unwinding of economic imbalances requires major structural adjustments. A failure to recognise a downshift in growth potential was a key reason why inflation got out of hand in the 1970s.

Not an easy time to be a central banker

Policymakers have a difficult path to tread, providing sufficient stimulus to prevent deflation, but removing it quickly enough to avoid excessive inflation without killing off the recovery. Investors are right to be nervous. Once price declines become entrenched it is very difficult to escape a downward spiral. History also cautions that high inflation is often the path of least resistance when debt burdens become too onerous - even though this is not the sort of de-leveraging (reduction in the real value of outstanding debt) anyone wants to see. **(RG)**

Main Macroeconomic Forecasts (%)				
	2008	2009	2010	2011
GDP	0.7	-4.0	-0.7	1.6
CPI	3.6	0.5	0.8	1.4
Unempl.	5.8	8.3	10.6	9.8

Source: RBS Group Economics

Chart 2: UK recession shaping up to be worst in a generation
(real GDP Index, business cycle peak =100)
Source: National Statistics

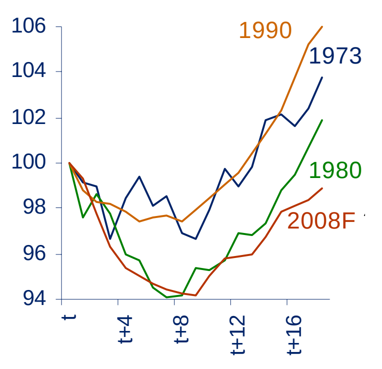


Chart 3: Saving rates will have to move up eventually
(savings/disposable income; in %)
Source: National Statistics

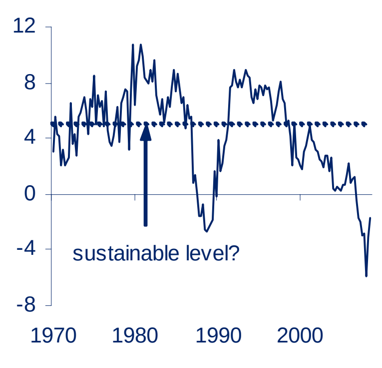
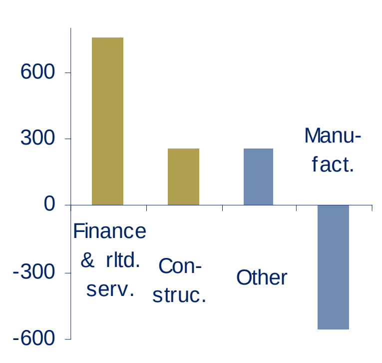


Chart 4: UK private sector jobs created 2003-2007
(thousands)
Source: Thomson Datastream



UK - Bleak House

Economic activity declined by 2.2% in the second half of 2008 alone - not far off the total 2.6% loss seen during the 1990s recession. But there is worse to come. The economy looks set to shrink by c4% this year, with recovery unlikely to begin until late 2010. This would make this recession as deep as the 1980s downturn (chart 2). The UK has been hit on two fronts. First, depressed global demand is preventing a classic export-led recovery, despite sterling's weakness. Second, repairing balance sheets in the household and corporate sectors is exerting an even greater drag.

Policymakers are adopting increasingly aggressive and unorthodox policies to mitigate the fallout from the crisis. But these measures will take time to have an effect. Moreover, they can only smooth, not avoid, the difficult shift to a more sustainable growth pattern. The transition to an economy that is less reliant on debt-financed consumption, housing and financial services, is going to be a long and difficult one. Indeed, the UK's trend growth rate is likely to be significantly lower than the c3% we became used to.

Financial consolidation and domestic demand - uneasy bedfellows

The private sector's number one priority is to repair debt-laden balance sheets. Households' debt-to-income ratio has never been higher, while the corporate sector's debt-to-equity ratio is close to the unsustainable levels seen after the 2001 stock market collapse. The main route to financial consolidation is via increased saving, and hence less spending. Take households: spending has exceeded income in every quarter since 2006 (chart 3). If saving reverts to its long-term average (5% of income), consumer expenditure would fall by £75bn - equivalent to 5% of all spending across the economy last year.

Rising unemployment is another powerful drag on domestic demand. Two sectors at the epicentre of the crisis - financial services and construction - accounted for the majority of jobs created in the private sector in the 2003-07 period (chart 4). This is unsurprising, since both grew more quickly than the rest of the economy. Now these sectors are leading the downturn. Redundancies in both sectors have jumped, contributing to the increase in the overall unemployment rate to 6.5%. Forward-looking indicators suggest that unemployment will climb towards 10% by the end of the year. Corporates are also likely to retrench, freeing up cash to repay debt. Given the weakness of final demand and rising spare capacity, investment spending is likely to be cut back severely. In sum, the structural shift towards higher saving is, by itself, enough to deliver a deep recession.

Powerful stimuli will eventually kick in

Depressed demand at home and abroad is the overwhelming force acting upon the economy in the near term. But, by the second half of 2010, activity is likely to begin to recover as debt is repaid and a powerful combination of stimuli starts to gain traction. Rate cuts may be less potent at boosting demand than in the past, but they will have a positive impact, not least in helping over-leveraged households to repair balance sheets. The Bank of England has cut rates to all-time lows and lowered borrowing costs for households and firms directly through bond purchases. The sharp depreciation in sterling induces consumers to shift away from more expensive imports, spending more on domestically-produced goods, and will help exporters - once the global economy recovers. Consumer price inflation is set to fall sharply, boosting purchasing power. Tax cuts and public spending will help put a floor under the economy until the recovery comes.

A new economy

This recession is likely to mark the start of a major shift in the structure of the UK economy. Debt-financed consumption on the scale of recent years is unlikely to return any time soon. People will save more and spending growth will be less marked. On the production side, the economy will become less reliant on financial services and housing. Instead, knowledge-intensive manufacturing and other export-oriented industries are likely to gain in importance, even though they will remain under severe pressure over the next two years. Ultimately, the recession is the pain the UK will have to endure to take it back to a more balanced, and therefore sustainable, growth trajectory. **(RB)**

Main Macroeconomic Forecasts (%)				
	2008	2009	2010	2011
GDP	1.1	-3.2	0.6	2.2
CPI	3.8	-1.3	1.0	1.8
Unempl.	5.8	8.8	9.7	9.4

Source: RBS Group Economics

Chart 5: Consumers and producers cutting back
(Index 2007=100)
Source: Thomson Datastream

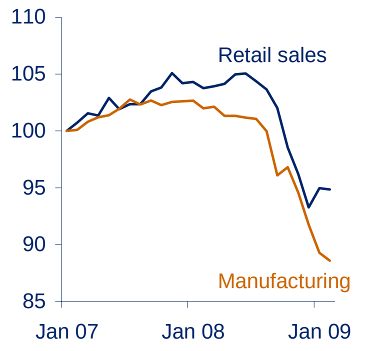
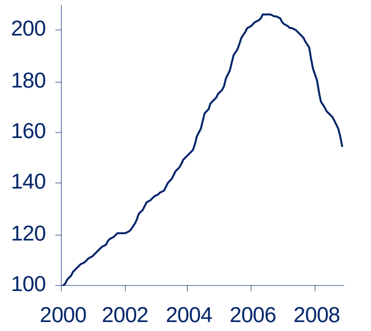


Chart 6: US house prices already some way off their peak, but have further to fall
(Case-Shiller Index – 20 City Composite)
Source: Thomson Datastream



United States - First in, first out?

The US economy contracted by the most in 27 years in Q4 2008 as the severity of the recession intensified. Unemployment has risen rapidly and fears of deflation have become acute. In response, the Federal Reserve has reduced the fed funds rate to zero, while intervening to lower long-term market rates and shore up the financial sector. The administration has passed an $800bn stimulus package. Nevertheless, the US faces the deepest, most protracted recession since at least the early 1980s. Household and corporate de-leveraging, financial market dislocation and necessary macroeconomic adjustments will drag on growth persistently, but the US may at least recover earlier than other industrialised regions.

The recession is deepening as policy struggles to gain traction

The US economy contracted by 6.2% (annualised) in Q4 2008, the sharpest fall since 1982, with consumer spending and investment down sharply. There were few signs of stabilisation at the start of 2009. Retail spending and industrial production fell by c10% y/y in January (chart 5). At 8.1% in February, unemployment has already eclipsed the 1992 peak of 7.8%, pointing to ongoing pressure on spending. Corporate insolvencies are rising - Moody's expects the default rate on corporate bonds to quadruple to 16%. With inflation close to zero and no growth, deflation could ensue. This would make a bad situation far worse, sapping demand and increasing the real cost of debt.

Policymakers are not standing idly by. The Fed has cut short-term rates to zero. In March it announced plans to purchase $300bn of government bonds to lower long-term interest rates and $1.25 *trillion* of agency mortgage backed securities (c30% of those outstanding) to bring down mortgage rates. The Treasury plans to purchase toxic assets and offer guarantees against losses to support the financial sector. A fiscal stimulus worth c6% of GDP (one-third tax cuts and two-thirds public spending) has been adopted and more direct support for the housing market is in the pipeline.

Despite this aggressive response, the economy is likely to record the deepest recession for 30 years, contracting by 2.6% in 2009. Credit markets are still not functioning normally, blunting the impact of the stimulus. As in the UK, households and firms need to repair balance sheets (pay down debt), while on the production side, the economy needs to import less and export more (no mean feat in the midst of a global recession). This will be a burden for some time, suggesting that the recovery will be fairly pedestrian.

The US entered, and so may exit, recession the earliest

But at least the US is likely to see growth return earlier than other industrialised economies - early, rather than late, 2010. This is not just because the US was first to enter recession; it is also making better progress in unwinding its imbalances. The difference between imports and exports - a gauge of how far an economy is living beyond its means - has narrowed dramatically, as domestic demand has slowed and energy prices have fallen.

There are also signs that financial consolidation is progressing in the household sector. After falling to its lowest level since the Great Depression, the savings rate has rebounded, reaching 5% in January - ten times the five-year average of 0.5%. The UK equivalent remains at -1.7%. Lower oil prices are likely to deliver more support to US consumers (due to a smaller tax wedge between wholesale and final petrol prices). US firms are, on average, less indebted than in Europe and employ a more varied financing mix, so corporate de-leveraging is likely to prove less painful and credit supply may recover faster.

Housing still poses a major risk to the outlook

The housing market could still throw a spanner in the works. Falling house prices are frustrating efforts to rebuild household wealth and are putting pressure on the ailing financial sector (undermining the value of mortgage-related assets). A stabilisation is therefore likely to be an essential ingredient to a sustained recovery. But demand is struggling to find a floor as the labour market situation worsens. Excess supply of homes on the market is being worsened by a glut of foreclosures. Eventually lower prices should tempt people into the market. Prices have fallen by 27% (chart 6). They could fall by 40% overall (i.e. from peak) before markets stabilise. **(GC)**

Main Macroeconomic Forecasts (%)				
	2008	2009	2010	2011
GDP	1.1	-3.2	0.6	1.1
CPI	3.3	0.3	0.8	1.7
Unempl.	7.5	9.5	11.0	11.0

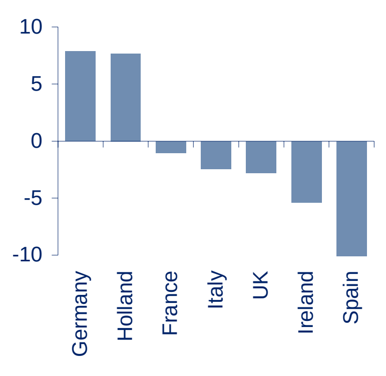
Source: RBS Group Economics

Euro area - A tale of two imbalances

The euro area has entered a deep recession. Two forces are battering the region. For more export-oriented economies like Germany, with high rates of domestic saving, the downturn in global trade is the main drag. Those at the opposite end of the spectrum, with trade deficits and debt-laden consumers (like Ireland and Spain, chart 7), are suffering as capital inflows dry up and they are forced to de-leverage in the wake of the financial crisis.

With public finances in a sorry state across much of the region, fiscal policy is relegated to a supporting role in bolstering activity. Against this backdrop, the European Central Bank's (ECB) reluctance to lower interest rates aggressively and adopt unorthodox policies is likely to have negative consequences. The euro area is likely to be the laggard when the world eventually emerges from this downturn.

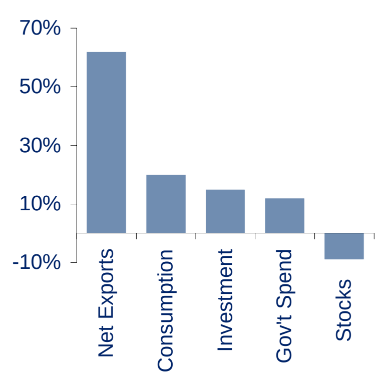
Chart 7: Current account balances
(% of GDP, 2008)
Source: Thomson Datastream



Export dependent Germany must start spending

Germany runs the largest trade surplus in the euro area. Since 2000, growth has averaged 1.5% a year, two-thirds of which came from net exports (chart 8). The synchronised nature of the current global downturn is rapidly reducing overseas demand - German exports fell 20% in January, dealing a heavy blow to the euro area's largest economy. Sparking domestic demand would be the best solution, but this goal has proved elusive, even in the best of times. Indeed, risk-averse consumers are likely to save more, not less, as the economy contracts, leaving the burden of adjustment squarely with the government. The €50bn stimulus package that has been announced will provide some support, but the economy still looks set to contract by 3% or more this year, with a meaningful recovery unlikely to surface until 2011 - easily the worst downturn since re-unification.

Chart 8: Contributions to German GDP growth (2000 to 2007)
Source: Thomson Datastream

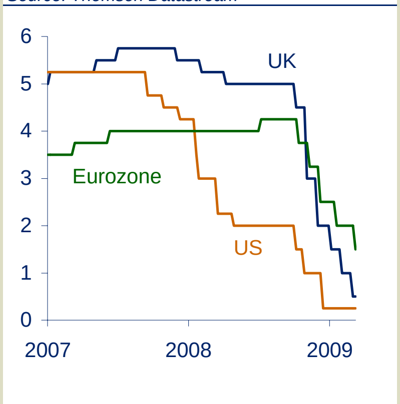


Highly leveraged countries must restore competitiveness

But the going is also tough in many of the economies which, in previous years, had been the euro area's star performers. The credit taps which supported growth in countries like Spain and Ireland have been turned off. These economies also have to deal with a stickier structural problem - years of rapid growth led to higher rates of inflation that have eroded competitiveness. There is no quick fix. Instead, wages will have to rise at a slower rate than their euro area compatriots. This is a big ask, given wage restraint in Germany and the reluctance of workers to accept nominal wage cuts. Moreover, the reliance of many countries on foreign savings to finance growing indebtedness is also a source of strain, as capital inflows dry up. Domestic saving must replace foreign saving, which will also deal a heavy blow to demand.

The situation is further worsened by the fact that many of the countries that are under most pressure are not in a position to provide a fiscal stimulus. Public finances are already strained. Debt levels are high (especially in Italy, Belgium and Greece), and recent sovereign debt downgrades will further increase the cost of government borrowing. Cushioning the slowdown will be difficult, suggesting the downturn will be deep and long.

Chart 9: ECB behind the curve?
(official interest rates)
Source: Thomson Datastream



Policy options - running out or out-running the slowdown?

The ECB has been more cautious lowering interest rates (chart 9) and has so far avoided more adventurous policy options, despite the dire outlook. In theory, unorthodox policies (like "quantitative easing") are just as possible within the euro area as elsewhere, although in practice there are more wrinkles to be ironed out. For example, if the ECB starts to buy bonds to lower long term interest rates, this raises questions over which countries' debt the ECB should purchase. But as the recession deepens, the ECB is likely to grudgingly follow the path forged by the Bank of England and start "creating money". Ironically, delay is likely to mean having to leave policy settings supportive for longer.

Being part of the euro area leads to policy constraints, like the inability to devalue currencies. Given the difficulties facing the region, this could pose a threat to the monetary union. But the risk is fairly remote. The costs of leaving the euro would be enormous, dwarfing any short-term benefits. Indeed, membership has saved some countries from currency crises they might otherwise have suffered. The downturn could even lead to closer ties if it results in greater fiscal co-operation or financial support. (**DR)**

Chart 10: Capital inflows to Eastern Europe down sharply
($bn)
Source: IIF

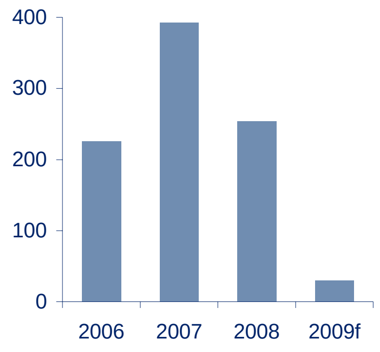
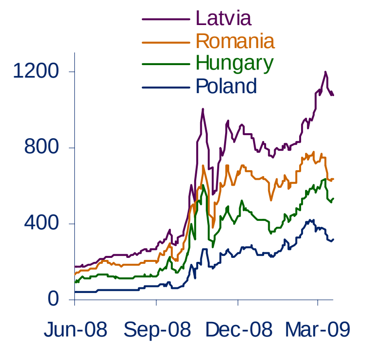


Chart 11: Sovereign risks rising
(CDS spreads, bps)
Source: Thomson Datastream



Box: A cold wind blows in the East

The global financial crisis is wreaking havoc across central and eastern Europe (CEER). In a number of respects the problems are reminiscent of the 1997 Asian Crisis. Risk-averse investors have shied away, making it hard to fund large trade deficits and putting exchange rates under pressure. Weaker currencies are making it difficult to service the large stock of foreign currency debt (much of which is un-hedged) and placing enormous strains on financial systems. But, unlike the Asian crisis, the rest of the world is unable to help the region export its way out of trouble.

Weaknesses exposed

The region had enjoyed years of strong capital inflows in the run up to the global financial crisis. This created profitable investment opportunities for local firms and spurred employment. Ever closer ties with the EU helped to bring down interest rates, and increasing integration with the euro area banking system fuelled credit growth, boosting domestic demand. The weakness of this growth model is being exposed. The flipside of foreign capital pouring into the region was surging asset prices, mounting debts (often denominated in foreign currency) and persistent trade deficits - all classic ingredients for macroeconomic instability, as painfully illustrated during the 1997 Asian financial crisis.

Private capital flows have already collapsed (chart 10), with serious repercussions. Free-floating currencies in Poland, Hungary and Romania have already come under intense pressure, while those with fixed exchange rates (Croatia, Latvia, Ukraine) have seen their currency reserves fall sharply as investors headed for the exits. Given ongoing risk aversion and an increasing focus by international banks on their home markets, bank lending is also under pressure, aggravating already tough financing conditions.

Balance sheet pressures mount

Impaired balance sheets are likely to turn out to be the biggest problem. Households and firms have seen the local currency cost of servicing foreign currency debts shoot up as exchange rates have plummeted, pushing many towards default. Falling asset prices are an additional factor eroding wealth, leading to negative equity and increasing losses for investors in the event of default. Financial sectors are already facing funding difficulties, and spiking non-performing loans will make matters worse. Pressures are intensifying, since a large proportion of obligations are short-term liabilities that need to be refinanced this year.

Governments are constrained. Many entered the crisis with large budget deficits - a situation that is being aggravated by growing shortfalls in tax revenues. Since the start of the crisis in the summer of 2007, rating agencies have issued 27 downgrades of sovereign debt issuers in the region, with Latvia and Romania losing their investment grade status in the process. Equally worrying, foreign exchange reserves are insufficient in countries like Poland, Romania, Latvia and Ukraine to cover near-term trade deficits and external debt repayments. CDS spreads have widened dramatically (see chart 11), indicating that investors see an increasing risk of countries defaulting on their obligations.

Regional variation?

The outlook is challenging, but there are important differences across countries. Hungary, Romania and Latvia are in the most perilous position. Each has significant foreign currency debt. All three also have gaping trade and budget deficits. Moreover, official reserves fall short of their external funding requirement this year - the IMF will probably have to provide assistance to avert balance of payments problems.

Poland, the Czech Republic and Slovakia are better placed. Poland, the largest economy in the region, has developed domestic momentum and its public finances are in decent shape. The Czech Republic has limited foreign currency debt, while Slovakia is already a member of the euro area. A final challenge to the region is contagion. Some countries in Western Europe, notably Austria, Sweden and Greece, have large banking exposures to the region. If these countries curtail their banking activities, the region's prospects turn from bleak into something even more unpleasant. (**RB**)

Asia - The price of prudence

Too little spending and too much saving is not always a good thing, as it increases the sensitivity to global conditions. The trade linkages that propelled Asia to the spectacular growth rates it enjoyed over the past decade are also the root cause of the region's current ills. As the Western economies slip into recession, and the financial crisis squeezes trade finance, trade is slumping, taking a heavy toll on growth across Asia. Recovery will hinge on igniting domestic demand. In terms of the economies considered below, China appears well-placed, with India a distant second and Japan somewhere beyond the horizon.

Asia GDP Growth Forecasts (%)				
	2008	2009	2010	2011
Japan	-0.7	-6.3	0.3	1.0
China	8.7	5.0	7.5	8.0
India	6.0	4.9	6.3	6.5

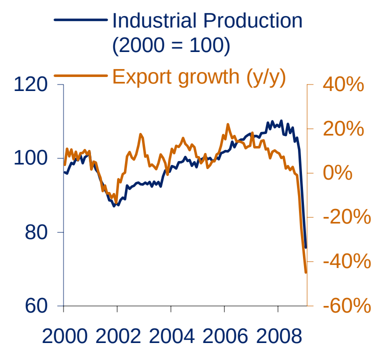
Source: RBS Group Economics

Japan - darkness falls in the land of the rising sun

Japan is already in the midst of its most severe recession since WW2. By December 2008, economic output was already 4.8% below its peak (for context - this is almost twice as bad as the UK's recession in the early 1990s). Things are still getting worse, with data releases at the start of the year nothing short of atrocious. Exports fell by 46% y/y in January, industrial production was down 30% over the same period (chart 12), taking output back to 1983 levels. Domestic demand, already anemic, is set to weaken further. Household spending will come under pressure as employers choose not to retain labour as they have done in previous downturns. The initial increase in unemployment to 4.3% in December came from cutting temporary workers, who receive fewer benefits and lower wages. The second stage will see overtime and bonuses cut and permanent staff made redundant.

Chart 12: Japan is slowing sharply

Source: Thomson Datastream



With output falling rapidly and price pressures non-existent, deflation is likely to return, adding to an already long list of difficulties. Falling prices will discourage big ticket purchases and increase the real burden of debt. It's hard to see how a quick turnaround can be achieved. Interest rates are already at 0.1%, the fiscal position is dire and the authorities appear reluctant to try unorthodox measures with the necessary gusto. An upturn will probably have to rely heavily on external demand - a tall order with all western economies set to contract in 2009 and the emerging world slowing sharply.

China - a slowdown that will feel like a recession

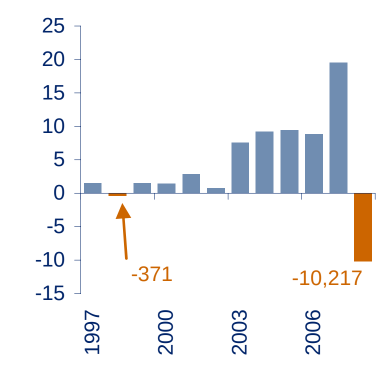
Growth fell to single digits in 2008 (9%) for the first time since 2002. Growth is likely to slow to 5% this year. This will feel like a recession, as it will be the weakest growth rate since 1990. Policymakers have been quick to act. A fiscal stimulus of $586bn over two years, equivalent to 7% of GDP, has been adopted. Robust public finances and large foreign exchange reserves ($1.9 trillion, equal to Italy's annual economic output) mean the authorities are well placed to provide a further boost if growth remains below the 8% annual target. Action has also been taken on the monetary front. Interest rates have been lowered by 216bps (to 5.31%) and the measures put in place last year to restrict credit growth have been reversed. Further easing is likely in the months ahead.

Exports are important, but they are not the lifeblood of the economy as they are in much of Asia. Strong domestic demand and an emerging middle class suggest China will fare better and will recover more quickly than its neighbours. The authorities were already trying to move further away from exporting low value-added goods. The rest of the region, especially Japan, could do with the boost that rising demand in China could provide.

Chart 13: Net investment flows to India have collapsed

(in $bn)

Source: Thomson Datastream



India - limited ammunition to battle the slowdown

Despite India's lower exposure to the global trade cycle, the current slowdown is proving sharp and comprehensive. The economic climate was relatively benign until Q4, when growth slowed to 5.6% y/y, well below the 5-year average of 9%. Industrial production saw the first contraction since the 1993 recession, while exports suffered their most serious decline since the Asian Crisis. Interest rates have been lowered, but the impact has been muted to date. This is no surprise. The evaporation of foreign investment has removed a vital source of capital (chart 13). The large public sector borrowing requirement also makes it more difficult for domestic firms to access funds, crowding out private investment. Weak public finances also mean limited scope for higher government spending. Against this backdrop, growth looks set to slip below 5% in 2009. **(DR)**

Oil - Where next?

As the global economy has entered recession, energy prices have fallen dramatically (chart 14). But trading conditions remain volatile, with large price swings the rule rather than the exception. In this article we present our forecast for energy prices and the balance of risks going forward.

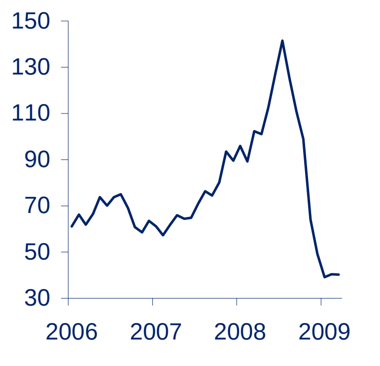
Demand takes a hammering as global activity plummets

In the current environment, demand destruction is the dominating theme. Energy prices are likely to undershoot their long-term equilibrium, which we peg at $65 to $75 per barrel. In the Western world the impending slowdown looks increasingly like the early 1980s recession. The fallout has spread to emerging markets - a significant blow given the disproportionate role in boosting energy demand in recent years.

It is difficult to see how prices will go up in the midst of a global recession, but easy to see how they can fall further. Major players in the oil industry have taken steps to protect themselves from further downward price movements. For example, Mexico is hedging its oil exports at a cost of US$1.5 billion. OPEC has announced proposals to cut production to stem the slide of oil prices (chart 15). The cartel would like to see the oil price in the region of $70 -$80 per barrel, which will maintain strong investment levels in the sector. OPEC's and Russia's announcements of aggressive production cuts have the whiff of desperation as their oil revenues are plummeting.

A long term equilibrium price of $65-$75 per barrel feels right. We do not foresee crude oil prices returning to levels at the beginning of this decade when we saw oil prices at lows of c$10. The shortage of investment over a number of years in the sector and a tight supply of equipment and personnel are the main reasons. Nevertheless, a return to the all time highs of $150 is highly unlikely given the extent of the decline in demand to date.

Chart 14: A precipitous drop in oil prices
(WTI, $ per barrel)
Source: Energy Information Administration,

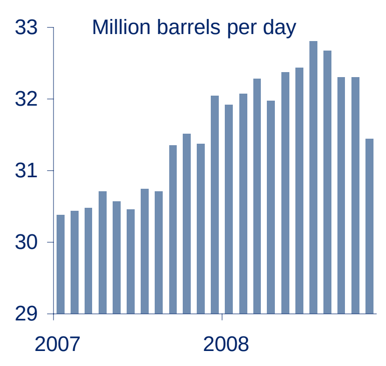


Potential for a sharp rebound when the recovery comes?

Some planned investment for exploration is being deferred, due to tight credit and related financing issues and general uncertainty. In particular, smaller businesses and recent start-ups, which focus on technology-intensive exploration, development and production, have been affected. In contrast, larger integrated companies have enjoyed strong cash flows and have been able to build significant war chests during the boom years.

Nevertheless, a lack of investment during the downturn may give way to tight capacity once the global economy recovers. Underinvestment will remain a problem after the economy rebounds, because the oil rich OPEC states continue to view their industry as a strategic asset, limiting foreign direct investment. Therefore, investment will remain significantly below the level that would prevail in a more competitive market.

Chart 15: Moderate reduction in OPEC production to date
Source: Energy Information Administration



Scenarios – near-term risks skewed towards lower prices

We have prepared three scenarios, considering the forces that could emerge pulling prices higher and lower over the next three years (see table). However, it should be noted that these scenarios are not symmetric. Prices are likely to be below the baseline over the next two years, while higher prices are the main risk after 2011. Indeed, the factors that drive prices down in the near term may well sow the seeds for price spikes in the future.

- **Baseline**. Under our Baseline scenario , markets respond to current conditions of falling demand and prices reflect the underlying supply and demand fundamentals.
- **Downside**. Downside risks on the demand side include a further deepening of the global recession resulting in further reduction in energy demand from the West coupled with falling, or at least significantly slower, energy demand growth in emerging markets.
- **Upside** Given the slowdown that has already occurred in global demand a meaningful recovery in prices is hard to envisage before the latter half of 2010. Under this scenario, the lack of investment during the downturn quickly gives way to tight capacity and an earlier and more vigorous global recovery takes hold in 2010. **(Thorsten Fischer)**

Oil Price Scenarios (US$/barrel)

	2009	2010	2011	2012
Base	49	55	60	70
Up	60	70	82	90
Down	35	40	45	65

Source: RBS Group Economics

Interest and Exchange Rate Forecasts

RBS GROUP ECONOMICS INTEREST AND EXCHANGE RATE FORECASTS							
	EXCHANGE RATES (End-of-Period)				INTEREST RATES (%, End-of-Period)		
	$ per £	$ per EUR	£ per EUR	$/JPY	Euro Refi Rate	US Funds Rate	UK Bank Rate
2008 Q1	1.99	1.58	0.80	99.54	4.00	2.25	5.25
Q2	1.99	1.58	0.79	106.01	4.00	2.00	5.00
Q3	1.78	1.40	0.79	106.17	4.25	2.00	5.00
Q4	1.55	1.44	0.93	90	2.50	0.25	2.00
2009 Q1	1.46	1.36	0.93	94	1.50	0.25	0.50
Q2	1.44	1.30	0.90	90	1.00	0.25	0.50
Q3	1.45	1.25	0.86	90	1.00	0.25	0.50
Q4	1.48	1.21	0.82	90	1.00	0.25	0.50
2010 Q1	1.48	1.18	0.80	92	1.00	0.25	0.50
Q2	1.51	1.18	0.78	95	1.00	0.25	0.50
Q3	1.54	1.17	0.76	95	1.00	0.25	0.50
Q4	1.54	1.17	0.76	95	1.00	0.25	0.50
2011 Q1	1.60	1.20	0.75	95	1.00	0.75	0.50
Q2	1.60	1.20	0.75	95	1.25	1.25	1.00
Q3	1.60	1.20	0.75	95	1.50	2.00	1.50
Q4	1.60	1.20	0.75	95	2.25	2.50	2.00

Please see our monthly Interest and Exchange Rate Forecast document for regular updates

Key Central Bank Monetary Policy Meetings in 2009	
Bank of England	9 Apr, 7 May, 4 Jun, 9 Jul, 6 Aug, 10 Sep, 8 Oct, 5 Nov, 10 Dec
US Federal Reserve	29 Apr, 24 Jun, 11 Aug, 22 Sep, 4 Nov, 15 Dec
European Central Bank	2 Apr, 7 May, 4 Jun, 2 Jul, 6 Aug, 3 Sep, 8 Oct, 5 Nov, 3 Dec