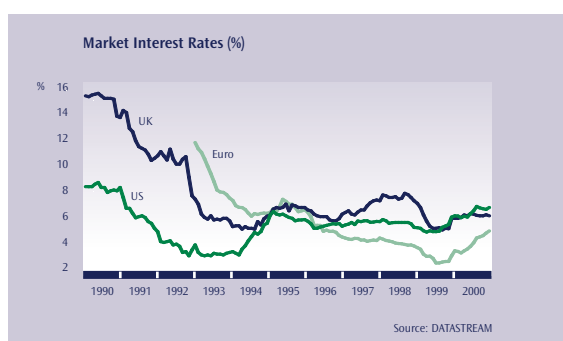


International Interest Rate Outlook

Pause in Tightening in UK and US

We have reached a pause in terms of the process of official interest rate tightening that was initiated by the major central banks in 1999. The Bank of England's Monetary Policy Committee has been on hold since February 2000 while the US Federal Reserve last raised rates in June 2000. It has to be acknowledged that nominal official rates at 6.5% in the US and 6% in the UK are high in real terms. The case for aggressive tightening beyond their current levels is very limited. However, the latest minutes from the Bank of England's MPC show that the decision to leave rates unchanged has been a close call in recent months.



Real Rates are High

In the euro area, the ECB has continued to tighten rates but from a relatively lower nominal base than in the US and UK. The ECB raised the minimum refinancing rate to 4.75% on 5 October, representing the seventh upward adjustment of interest rates since the commencement of tightening in November 1999. Using core inflation rates as a deflator for measuring real official interest rates, we find that real rates stand at 4% in the US 3.8% in the UK and 3.4% in the euro area.

In view of the different positions of the euro area in the economic cycle, the relatively lower real interest rate in the euro area is not inappropriate but is close to the UK. However, compared with the US and the UK, it appears that there is more scope for higher rates in the euro area given the early stage of the economic expansion in the euro area and the ECB's hawkish stance to date.

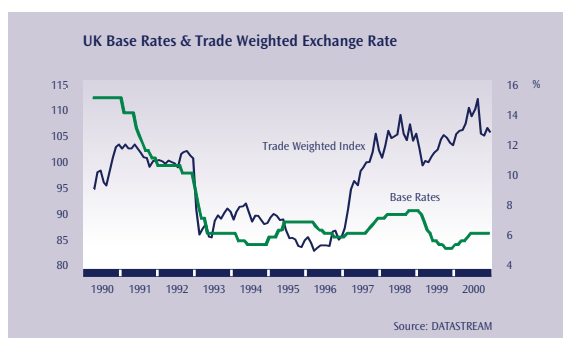
Fed and Bank of England Near Peak

In the US, the Fed has adopted a wait and see approach to interest rate policy. Rates were left unchanged after the FOMC meeting on 3 October. The Fed has maintained its bias towards further tightening in view of the perceived imbalances between supply and demand in the US economy. Latest economic data show that though some of the key sectors of the economy cooled in Q2 '00, the growth in real GDP is expected to remain strong over the remainder of 2000. Real GDP is forecast to rise by 5.2% this year. However, as outlined in the section on the US economy, we envisage a slowdown in US real GDP growth to 3% in 2001. This should help to cool inflationary pressures in the course of 2001. As a result, while the Fed may not have finished its tightening of official rates, because core inflation could move to 2.75% or higher, a peak is expected around 6.75%, or at worst 7%. We have incorporated a rise to 6.75% into our summary table but see this as only a 50-50 risk. We envisage that the Fed will commence a move to lower nominal rates in the course of 2001 as underlying inflation eases back below 2.5%.

In the UK, the Bank of England's Monetary Policy Committee (MPC) may raise rates by a further 0.25% before the end of the year or in Q1 '01. Rates were left unchanged after the MPC meeting on 4-5 October. The MPC will maintain its stance of targeting the inflation rate close to the 2.5% official limit. With the government intent on raising public expenditure, the MPC will seek to achieve a slowdown in the growth in private sector domestic demand by keeping a relatively tight hold on interest rates. Furthermore, with some doubts emerging about sterling's long term prospects against the US dollar, the MPC will remain alert to exchange rate induced inflationary pressures. We expect base rates to remain unchanged throughout the first half of 2001 and to fall back to 6% in the latter half of the year from the possible peak of 6.25%.

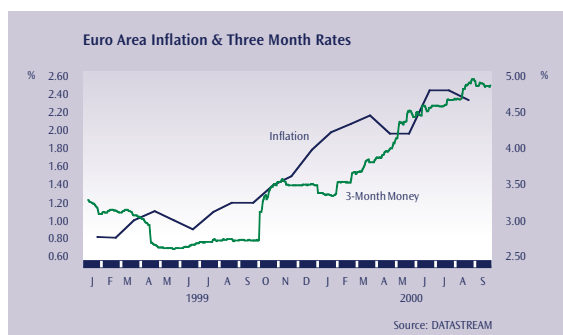
Current Stance of Monetary Policy						
	Official Rates (%)	Latest Headline Inflation (%)	Latest Underlying Inflation (%)	Real Official Rates (%) (based on underlying inflation)	Latest GDP Growth (%)	Non Inflationary Growth Potential (%)
US	6.5	3.4	2.5	4.0	6.1 (Q2 '00)	4.0
UK	6.0	3.3	2.2	3.8	3.2 (Q2 '00)	2.5
EURO	4.75	2.3	1.3	3.45	3.8 (Q2 '00)	2.25

International Interest Rate Outlook



ECB Has Further To Go On Rates

The European Central Bank faces a dilemma on interest rate setting. The ECB's narrow interpretation of its mandate to maintain price stability within the upper limit of 2% has meant that interest rates have risen sharply over the past year by 2.25 percentage points. It will take time for these increases to work through the economy, which is currently growing at over 3.5%. However, with the German IFO survey and the eurozone PMI survey pointing to a slowdown in the growth in industrial production in Germany and in the eurozone in the months ahead, the markets believe that economic growth has peaked in the euro area as a whole. Higher oil prices will also impact negatively on euro area economic growth. The market, therefore, sees little room for further rate increases by the ECB. The market also believes that higher interest rates would be counterproductive for the euro. Nevertheless, with the ECB worried about the short term outlook for inflation, there is scope for the minimum refinancing rate to rise by another 0.25% before the end of 2000 even after the move of 0.25% on 5 October. However, the ECB could wait until 2001 before further action.



Looking to 2001, there are some conflicting issues for the ECB in terms of interest rate policy. First, the euro is foremost to stage a modest recovery, which would help to contain imported inflation. Furthermore, our oil price assumptions would, per se, result in a lower headline rate of inflation in the second half of 2001. The ECB would have to be careful about raising official interest rates in an environment where monetary conditions were tightening due to a stronger exchange rate and where global economic growth was slower than in 2000. However, economic growth in the euro area could turn out to be more robust than many euro sceptics believe. Real GDP could continue to grow in excess of 3.5% due to "New Economy" effects. If the ECB believes that the non-inflationary growth potential of the eurozone is stuck at about 2.25%–2.5%, the ECB could be persuaded to tighten policy from the viewpoint of the medium term outlook for inflation in the euro area, in the event of growth remaining above 3.5%.

Our inflation forecasts for the eurozone and for other economies envisage a moderation in the headline rate of inflation in 2001, but core or underlying rates could be higher next year than in 2000 due to secondary price effects arising from the high price of energy products in 1999/2000. On balance, therefore, we believe that the ECB will continue to raise official rates on a gradual basis in 2001, with the minimum refinancing rate rising to 5.25% by mid 2001.

In Japan we envisage that as the economy builds on its recovery, the Bank of Japan will raise rates by a cumulative 0.50% from current levels by end 2001.

International Interest Rate Outlook

Interest Rate Forecast		End Period				
%	Current	Q4 '00	Q1 '01	Q2 '01	Q3 '01	Q4 '01
US						
Fed Funds	6.50	6.50	6.75	6.75	6.50	6.25
3 Month	6.69	6.75	6.95	6.85	6.50	6.00
2 Year	5.98	6.05	6.20	6.10	6.00	5.80
5 Year	5.87	5.95	6.10	6.00	5.90	5.70
10 Year	5.82	5.85	5.90	5.85	5.95	5.55
Euro						
Refi Rate	4.75	4.75	5.00	5.25	5.25	5.25
3 Month	4.85	5.10	5.10	5.35	5.35	5.35
2 Year	5.12	5.20	5.30	5.44	5.50	5.35
5 Year	5.16	5.25	5.35	5.50	5.50	5.50
10 Year	5.34	5.40	5.50	5.65	5.60	5.50
UK						
Base Rate	6.00	6.00	6.25	6.25	6.00	6.00
3 Month	6.13	6.15	6.40	6.35	6.00	6.00
2 Year	5.90	6.00	6.10	6.15	5.80	5.75
5 Year	5.72	5.75	5.85	5.90	5.70	5.60
10 Year	5.31	5.35	5.45	5.50	5.40	5.50
Japan						
ODR	0.50	0.50	0.75	0.75	1.00	1.00
3 Month	0.43	0.40	0.65	0.90	1.15	1.15
2 Year	0.53	0.70	0.85	1.10	1.35	1.35
5 Year	1.19	1.20	1.45	1.70	1.90	2.00
10 Year	1.86	1.85	2.00	2.20	2.40	2.50