# Interest & Exchange Rate Forecast

5 October 2012

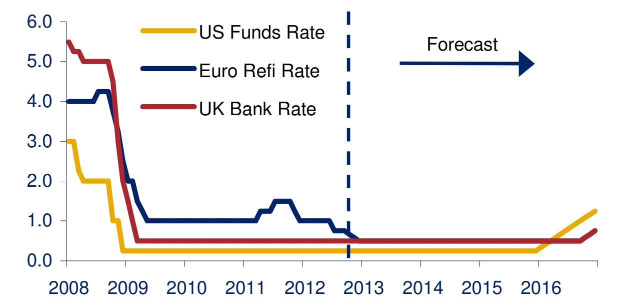
**UNITED KINGDOM:** There was no change from the Monetary Policy Committee (MPC) in October. But there have been some relatively encouraging economic signs over the past month, which is a change! The contraction in Q2 GDP was revised up to -0.4%q/q (the initial estimate was -0.7%). This probably means that without the extra bank holiday in June, Q2 activity would have been flat rather than falling. Moreover, employment continues to grow and is now within a whisker of its pre-recession peak. And CPI inflation edged down to 2.5% in August, helping to ease the squeeze in real take-home pay. But this doesn't change the overall picture of an extremely weak economy. The deterioration in the public finances, driven by lower tax receipts, is a good reminder of the uphill challenges the UK faces. As a result, the MPC is likely to extend its quantitative easing (QE) programme by another £50bn when it next meets in November.

**UNITED STATES:** Last month's meeting of the Federal Open Market Committee (FOMC) delivered more QE and more guidance on how long interest rates would stay low. Policymakers now expect the Federal Funds rate to stay exceptionally low "at least through mid-2015", six months longer than their previous guidance. In announcing further QE, the Fed took the unusual step of not specifying the total amount of assets it intends to buy. Rather, the Fed just indicated that it will buy $40bn of mortgage-backed securities per month until the outlook for the labour market improves substantially. It left itself enough room to vary the pace or to use other policies as conditions dictate, but this still amounts to an open-ended commitment. With unemployment at 7.8% and most Fed members expecting it to have fallen to only 6-7% by the end of 2015, this round of QE could last for a very long time. Fortunately for the committee the other side of its mandate, inflation, is behaving itself. PCE inflation is below the 2% target and absent any commodity shocks, shows little sign of taking off. We expect the Fed to lower its profile as Presidential election campaigning intensifies. Thus it is unlikely that the October meeting will herald further policy change. By the time of Chairman Bernanke's next FOMC press conference in December, he'll be hoping a deal to avert the pending fiscal cliff will be in place, but that could be a big ask so soon after the election.

**EUROZONE:** The European Central Bank (ECB) left interest rates unchanged at 0.75% at its October meeting. With much attention focused on the ECB's new sovereign bond buying scheme launched last month – Outright Monetary Transactions (OMTs) – ECB President Mario Draghi was at pains to stress the importance of the conditionally element. The ECB will activate the programme only after governments commit to strict fiscal consolidation and structural reform plans. Crucially, it will halt the programme if fiscal plans are subject to review and exit the programme if governments fail to fulfil their fiscal promises. As hoped, the OMT had a quiet but good start. Though it remains clientless, its mere announcement helped to reduce sovereign borrowing costs for the likes of Spain and Italy as markets acknowledge the potential of the scheme. But overall economic conditions in the monetary block remain poor. Recent survey data indicate that the labour market and business conditions will remain challenging given the continued slowdown in economic activity as both domestic and global demand remain weak. Worryingly, with the Eurozone almost certainly in recession, more austerity is on its way.

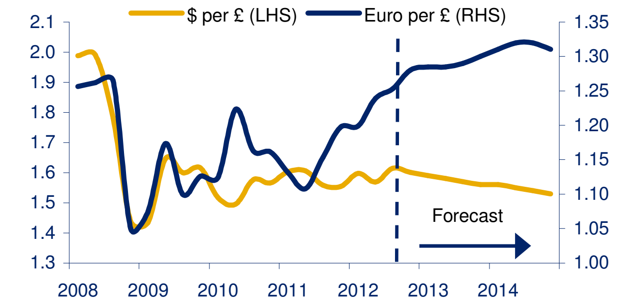
**Interest Rate Forecast (%)**

Source: Thomson DataStream, RBS Group Economics




**Exchange Rate Outlook**

Source: Thomson DataStream, RBS Group Economics

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**EUROZONE (CONT):** Spain has launched its fifth round of spending cuts and tax rises in an effort to meet its aim of reducing the country's deficit to 4.5% of GDP in 2013, from 8.9% last year. It is also hoping to avoid having to formally request assistance via the OMT programme. This is highly unlikely and a formal request seems to be a question of when, not if. France too has announced austerity measures, aimed at eliminating the deficit by 2017. But its focus is on tax increases for big companies and the wealthy, rather than spending cuts. And Greece is expected to make further cuts of €11.5bn in order to receive its next tranche of bailout funds. Further fiscal tightening will require more monetary stimulus to support growth. Thus we expect the ECB to lower rates by the end of the year.

## Exchange Rates

September saw central banks across the world step up their stimulus efforts. While much has been discussed about the further QE announcements in the UK and US, the Bank of Japan also got in on the act, announcing a JPY 10tn expansion to its asset purchase plan. QE is typically expected to weaken a currency as the additional liquidity is transferred to foreign denominated assets, or as yields (interest rates) fall in the domestic economy, reducing demand for the local currency. When many countries pursue QE at the same time, it makes predicting exchange rate even harder. With central banks likely to continue using QE to provide extra stimulus, this uncertainty around exchange rates looks here to stay.

Over the past month price action has broadly favoured the euro. The single currency has enjoyed something of a rebound following the ECB's OMT policy announcement. GBP/EUR fell to 1.25 from 1.28 in mid August, with the euro's performance even more pronounced against the dollar. While we are encouraged by the OMT programme, we remain of the opinion that the Eurozone crisis is far from solved. And though helpful, the OMTs are no silver bullet. As such, we would expect the euro to give back much of the ground gained recently, and indeed this has already started to happen. GBP/USD pushed to the higher part of its 1.53-1.63 range over September on the back the new round of QE in the US. We expect this exchange rate to continue to trade around 1.60 towards the end of the year, with concerns over the US fiscal cliff potentially dampening any dollar recovery against sterling.

| **RBS Group Economics Interest and Exchange Rate Forecasts** | | | | | | | |
|---|---|---|---|---|---|---|---|
| | **EXCHANGE RATES (end of period)** | | | | **INTEREST RATES (%, end of period)** | | |
| | $ per £ | $ per € | € per £ | ¥ per $ | Euro Refi Rate | US Funds Rate | UK Bank Rate |
| **2012 Q1** | 1.60 | 1.33 | 1.20 | 82 | 1.00 | 0.25 | 0.50 |
| **Q2** | 1.57 | 1.27 | 1.24 | 80 | 1.00 | 0.25 | 0.50 |
| **Q3** | 1.61 | 1.29 | 1.25 | 78 | 0.75 | 0.25 | 0.50 |
| **Q4** | 1.60 | 1.25 | 1.28 | 79 | 0.50 | 0.25 | 0.50 |
| | | | | | | | |
| **2013 Q1** | 1.59 | 1.24 | 1.28 | 80 | 0.50 | 0.25 | 0.50 |
| **Q2** | 1.58 | 1.23 | 1.28 | 81 | 0.50 | 0.25 | 0.50 |
| **Q3** | 1.57 | 1.22 | 1.29 | 83 | 0.50 | 0.25 | 0.50 |
| **Q4** | 1.56 | 1.20 | 1.30 | 85 | 0.50 | 0.25 | 0.50 |
| | | | | | | | |
| **2014 Q1** | 1.56 | 1.19 | 1.31 | 87 | 0.50 | 0.25 | 0.50 |
| **Q2** | 1.55 | 1.17 | 1.32 | 88 | 0.50 | 0.25 | 0.50 |
| **Q3** | 1.54 | 1.17 | 1.32 | 89 | 0.50 | 0.25 | 0.50 |
| **Q4** | 1.53 | 1.17 | 1.31 | 90 | 0.50 | 0.25 | 0.50 |

| **Key Central Bank monetary policy meetings for the remainder of 2012 and early 2013** | |
|---|---|
| **Bank of England** | 8 Nov, 6 Dec, 10 Jan, 7 Feb, 7 Mar, 4 Apr, 9 May, 6 Jun |
| **US Federal Reserve** | 24 Oct, 11 Dec, 30 Jan, 20 Mar, 1 May, 19 Jun, 31 Jul |
| **European Central Bank** | 8 Nov, 6 Dec, 10 Jan, 7 Feb, 7 Mar, 4 Apr, 2 May, 6 Jun |

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