RBS Group Economics

RBS Group

Interest & Exchange Rate Forecast

10 January 2013

UNITED KINGDOM: 2012 was a year of no growth and more policy easing. In 2013, we expect the opposite: no policy easing and more (but not much) growth. However, we are learning to expect the unexpected when it comes to the UK economy, so it's worth dwelling on a couple of the key uncertainties. On the outlook for growth, there is a minefield of challenges: companies are cautious about investment; consumer finances are still under pressure; and there is another five years of fiscal austerity to contend with. However we still think the European debt crisis is the biggest risk, given its impact on confidence, exports and financial markets.

On the outlook for monetary policy, the key question is how the committee would respond to any signs of renewed weakness. A rate cut seems highly unlikely and the MPC appears to be losing faith in quantitative easing. As a result, we could see other unconventional policies on the table. For example: giving more explicit guidance about the outlook for future policy or introducing a new target for monetary policy based on nominal GDP growth. Those changes will probably get more airtime in the summer, when Carney succeeds King as Governor. This month at least, the MPC was happy to leave interest rates at 0.5% and its asset purchase facility at £375bn.

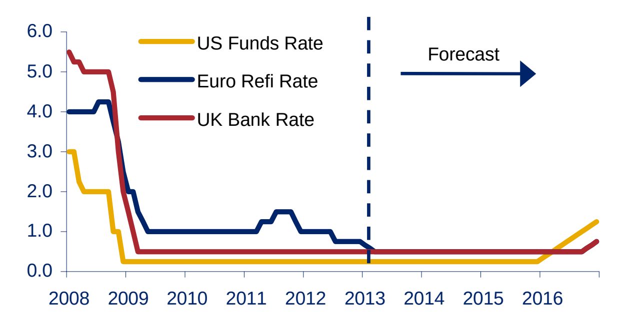
UNITED STATES: The hoped-for deal to avoid the fiscal cliff arrived just in time, but that is where the celebrations finished. Income tax rises on middle class households were cancelled, keeping $212bn of demand still in the consumer sector, but payroll taxes will still leave 77% of households worse off. The deal included only one spending provision, to keep paying unemployment benefits to those who have been out of work for more than a year. This was enough for Congress to agree to kick the “sequester” of automatic defence and entitlement cuts down the road to early March and avoid sending the US into an imminent recession.

The deal disappointed those who were hoping for a grand bargain. Fed Chairman Bernanke called for such a deal when he asked lawmakers to address not only the cliff, but also the debt ceiling and the long term budget deficit in his last news conference of 2012. How the US deals with the fall-out from this debacle will shape its prospects for 2013 and beyond. We have learned that governments typically respond to crises by doing just enough to avert disaster, but not much more. Consequently we expect any subsequent spending deal in March to be late, partial, and fail to address the long term budgetary challenges. What was a cliff will probably end up as a series of rocky drops.

With that in mind, we expect the Fed will be keeping the QE taps firmly open for the rest of this year as it compensates for the uncertainties in fiscal policy. That doesn’t mean the US will be a laggard in 2013 however. The labour market performed well in December as yet another month of job growth saw 155k more positions created. This means that 2012 ended with 1.8m more jobs than it started (or an even more spectacular 2.4m if you prefer the survey of households). Even so, that’s only budged the unemployment rate from 8.5% to 7.8%. Unless there is an acceleration of job creation we think it will take until the end of this year for the Fed to see the “substantial improvement” it is looking for to halt its latest QE programme.

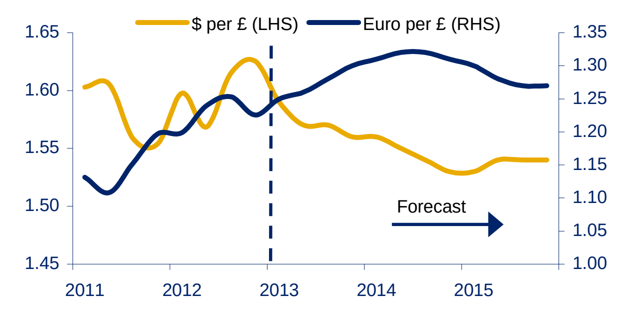
Interest Rate Forecast (%)

Source: Thomson DataStream, RBS Group Economics



Exchange Rate Outlook

Source: Thomson DataStream, RBS Group Economics



Contacts:
David Fenton
Group Economics
+44 131 626 3701
david.fenton@rbs.co.uk

EUROZONE: The European Central Bank (ECB) left interest rates unchanged at 0.75% at its January meeting. President Draghi noted recent improvements in financial conditions, but acknowledged that the economy will continue to face tough challenges in 2013. Austerity across the region is weighing on economic growth in both peripheral and core countries. November's unemployment rate of 11.8% reached yet another euro-era high. We expect the Eurozone to continue to "muddle through" its crisis in 2013. Politics will add further drama as both Italy and Germany are holding elections this year. Policy-wise we expect painfully slow progress on implementing the European banking union and allowing the European Stability Mechanism to recapitalise banks directly. Both of these measures are necessary to break the vicious circle of bank and sovereign stress.

Exchange Rates

Let's start the New Year with a review of the last. Sterling appreciated against the euro over the first half of 2012, with GBP/EUR peaking at 1.29 as the Eurozone crisis intensified. But the pound's progress was checked and partly reversed as ECB President Draghi pledged to do "whatever it takes" to keep the single currency intact. GBP/EUR closed the year just marginally higher it started it, at 1.23. Sterling has broadly moved sideways against the dollar, trading between 1.53 – 1.63 over the year. GBP/USD edged to the higher end of this band in late 2012 as fiscal cliff negotiations went to the wire.

Looking ahead, developments in the Eurozone debt crisis will be as important as ever. This week European Commission President Barrosso declared that the "existential threat against the euro has essentially been overcome". We beg to differ. Accordingly we are forecasting a weaker euro in 2013. Choosing the precise timing of the next Eurozone flare up is difficult, but we expect GBP/EUR to return to mid 2012 highs as we move through the year. Against the dollar the story is more subtle. A stronger recovery in the US and ongoing uncertainty in the global economy should support the dollar. This will however be tempered by frustratingly slow progress on US debt problems and a persistently loose monetary policy stance. We therefore expect GBP/USD to drift lower towards the middle of the 1.53 – 1.63 band.

RBS Group Economics Interest and Exchange Rate Forecasts							
	EXCHANGE RATES (end of period)				INTEREST RATES (%, end of period)		
	$ per £	$ per €	€ per £		Euro Refi Rate	US Funds Rate	UK Bank Rate
2013 Q1	1.59	1.27	1.25		0.50	0.25	0.50
Q2	1.57	1.25	1.26		0.50	0.25	0.50
Q3	1.57	1.23	1.28		0.50	0.25	0.50
Q4	1.56	1.20	1.30		0.50	0.25	0.50
					0.50	0.25	0.50
2014 Q1	1.56	1.19	1.31		0.50	0.25	0.50
Q2	1.55	1.17	1.32		0.50	0.25	0.50
Q3	1.54	1.17	1.32		0.50	0.25	0.50
Q4	1.53	1.17	1.31		0.50	0.25	0.50
					0.50	0.25	0.50
2015 Q1	1.53	1.18	1.30		0.50	0.25	0.50
Q2	1.54	1.20	1.28		0.50	0.25	0.50
Q3	1.54	1.21	1.27		0.50	0.25	0.50
Q4	1.54	1.21	1.27		0.50	0.25	0.50
First expected interest rate hike:					Q4 2016	Q1 2016	Q4 2016

Key Central Bank monetary policy meetings for 2013	
Bank of England	7 Feb, 7 Mar, 4 Apr, 9 May, 6 Jun, 4 Jul, 1 Aug, 5 Sep, 10 Oct, 7 Nov, 5 Dec
US Federal Reserve	30 Jan, 20 Mar, 1 May, 19 Jun, 31 Jul, 18 Sep, 30 Oct, 18 Dec
European Central Bank	7 Feb, 7 Mar, 4 Apr, 2 May, 6 Jun, 4 Jul, 1 Aug, 5 Sep, 2 Oct, 7 Nov, 5 Dec