RBS Group Economics

RBS Group

Interest & Exchange Rate Forecast

08 February 2013

UNITED KINGDOM: No policy change in February. GDP contracted in the final three months of 2012 (-0.3%q/q). This meant the UK economy failed to grow last year. Ordinarily, a weak outturn like that might have led to a loosening of monetary policy. But the Monetary Policy Committee (MPC) seems to think that it is near the limit of what it can meaningfully do to stimulate the economy. As Mervyn King said in a recent speech, “generalised monetary stimulus alone...is not a panacea”. But Governor King’s successor may have other ideas. Mark Carney is on record as saying that monetary policy is not “maxed out”. In other words, central banks can, and should, do more to help economies reach what he calls “escape velocity” (the point at which recovery is firmly on track).

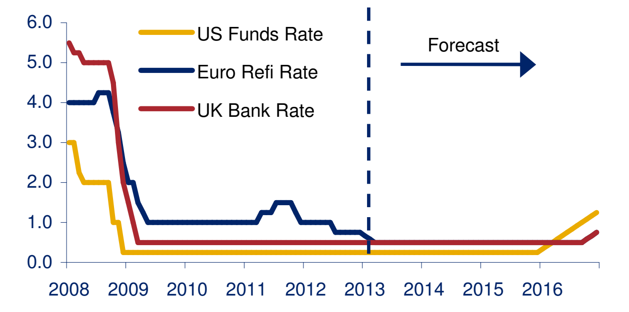
So how might policy differ when the Carney era begins? There were two key insights from his recent testimony to the Treasury Select Committee. First, we can expect more forward guidance on the future path of interest rates. This guidance won’t be a promise, but it should reduce uncertainty for businesses and households. Second, Mr Carney isn’t quite the maverick he has been painted as. He said he was “far from convinced” about the merits of switching to a nominal GDP target. On deficit financing, he couldn’t “envisage any circumstances where [he] could support that as a strategy”. Of course, all that could change once he gets his feet under his new desk at Threadneedle Street – especially if the UK remains in its current torpor.

UNITED STATES: Headline GDP growth stalled in the last quarter of 2012, showing the economy shrinking at an annualised rate of 0.1%. But temporary factors played havoc with the result, masking decent underlying strength. The biggest anomaly was defence spending that plunged 22% in Q4 (annualised). This alone pulled headline GDP down by 1.3%. Inventories and net exports also weighed down on growth. But all of this hid the 2.2% rise in consumption and an 8.4% rise in investment. Taken alongside the slowly improving labour and housing markets, this paints a positive picture for the US. And the outlook would be a lot more positive if not for the uncertainty around the US fiscal position. Having recently agreed to push the debt ceiling debate back until May, President Obama asked Congress to delay the sequester of automatic spending cuts due to take effect from March. Policymakers’ appetite for last-minute deals is clearly waning. It was little surprise then that the Fed chose to leave policy as is at the end of January. Its purchases of $40bn in mortgage-backed securities and $45bn long term treasuries each month will continue.

EUROZONE: In a unanimous decision, the European Central Bank (ECB) left its main interest rate unchanged at 0.75% at its February meeting. Speaking after the announcement, ECB President Mario Draghi noted that the economic weakness in the Eurozone is likely to prevail over the early part of 2013, with a gradual recovery later in the year. President Draghi also remarked that governments needed to progress fiscal consolidation, improve competitiveness and continue with labour market reforms. In terms of competitiveness, French President Francois Hollande has raised concerns about the strength of the euro, suggesting that efforts to improve competitiveness could be destroyed by the rising value of the currency.

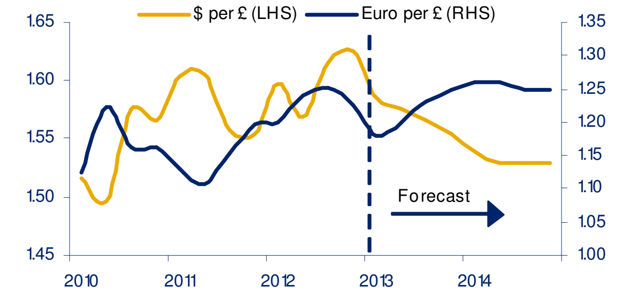
Interest Rate Forecast (%)

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 (CONT): Mr Hollande suggested that Eurozone heads of states should agree a medium-term exchange rate. This puts him at odds with other European leaders, notably the German Chancellor who has spoken out against countries trying to deliberately weaken their currencies. President Draghi was also clear that the ECB does not have an exchange rate policy. Nonetheless, being cognisant that the value of the euro can have an impact on the euro area's recovery, Draghi noted that the ECB would monitor the situation with respect to their assessment of risks to price stability.

Exchange Rates

Winter skiing in the Eurozone is looking more expensive following a sharp depreciation in sterling. GBP/EUR is currently trading at 1.18 – almost 10% below the mid 2012 high. Around half of this fall came in January as investors reacted positively to signs that the Eurozone crisis is easing. Is the renewed faith in the euro justified? We have argued that there remains significant work to be done before the crisis is fully resolved. But recent steps do seem to have lessened the risk of a break-up of the currency union. If policymakers continue to achieve slow-but-steady progress on safeguarding the union we will need to lower our current GBP/EUR forecast. Sterling also lost ground against the dollar last month, but GBP/USD remains in the middle of the 1.53 – 1.63 range that held through 2012. Certainly the US remains firmly ahead of the UK on its road to recovery. We therefore expect the dollar to strengthen against sterling over 2013 barring any nasty surprises from US fiscal negotiations.

While sterling remains the most important currency for our readers, recent action in FX markets has centred on the Japanese yen. A new inflation target and a more aggressive central bank brief imply that we will see much looser monetary policy in Japan (via both conventional and unconventional means). Markets are already trying to price in the implications for the JPY which has lost a quarter of its value against the euro and almost a fifth against the dollar in a matter of months. The scale of depreciation has big implications for global trade and is unlikely to be warmly received in Washington or key European capitals. Could FX be set to get much more political?

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	1.58	1.34	1.18		0.50	0.25	0.50
Q2	1.57	1.31	1.20		0.50	0.25	0.50
Q3	1.56	1.27	1.23		0.50	0.25	0.50
Q4	1.55	1.24	1.25		0.50	0.25	0.50
					0.50	0.25	0.50
2014 Q1	1.54	1.22	1.26		0.50	0.25	0.50
Q2	1.53	1.21	1.26		0.50	0.25	0.50
Q3	1.53	1.22	1.25		0.50	0.25	0.50
Q4	1.53	1.22	1.25		0.50	0.25	0.50
					0.50	0.25	0.50
2015 Q1	1.53	1.22	1.25		0.50	0.25	0.50
Q2	1.54	1.23	1.25		0.50	0.25	0.50
Q3	1.54	1.23	1.25		0.50	0.25	0.50
Q4	1.54	1.23	1.25		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 Mar, 4 Apr, 9 May, 6 Jun, 4 Jul, 1 Aug, 5 Sep, 10 Oct, 7 Nov, 5 Dec
US Federal Reserve	20 Mar, 1 May, 19 Jun, 31 Jul, 18 Sep, 30 Oct, 18 Dec
European Central Bank	7 Mar, 4 Apr, 2 May, 6 Jun, 4 Jul, 1 Aug, 5 Sep, 2 Oct, 7 Nov, 5 Dec

This material is published by The Royal Bank of Scotland plc ("RBS") which is authorised and regulated by the Financial Services Authority for the conduct of regulated activities in the UK. It has been prepared for information purposes only and does not constitute a solicitation or an offer to buy or sell any securities, related investments, other financial instruments or related derivatives ("Securities"). It should not be reproduced or disclosed to any other person, without our prior consent. This material is not intended for distribution in any jurisdiction in which its distribution would be prohibited.

Whilst this information is believed to be reliable, it has not been independently verified by RBS and RBS makes no representation, express or implied, nor does it accept any responsibility or liability of any kind, with regard to the accuracy or completeness of this information. Unless otherwise stated, any views, opinions, forecasts, valuations, or estimates contained in this material are those solely of the RBS Group's Group Economics Department, as of the date of publication of this material and are subject to change without notice. Recipients of this material should make their own independent evaluation of this information and make such other investigations as they consider necessary (including obtaining independent financial advice), before acting in reliance on this information.

This material should not be regarded as providing any specific advice. RBS accepts no obligation to provide any advice or recommendations in respect of the information contained in this material and accepts no fiduciary duties to the recipient in relation to this information. This document is classified as public.