# Interest & Exchange Rate Forecast

8 March 2013

**UNITED KINGDOM:** The Monetary Policy Committee (MPC) left quantitative easing (QE) unchanged and interest rates on hold at its March meeting. But further loosening seems likely given the fragile state of the recovery and the fact that support for QE seems to be enjoying a revival. Data over the past month have done little to change the overall story: inflation is above target (2.7%) and the economy is generating plenty of new jobs (+584k in 2012), but output is flat with little sign of improvement from business surveys in Q1.

Frustration with that slow pace of recovery prompted three members of the MPC – including Governor King – to vote for more QE in February. Will more opt for this form of stimulus in the months ahead? It's difficult to say: the case for QE depends not just on the outlook for the economy, but also on how effective members think it would be. On balance, we expect to see another £50 billion of QE in the second half of the year, alongside more explicit forward guidance on the future path of interest rates once the Carney era begins.

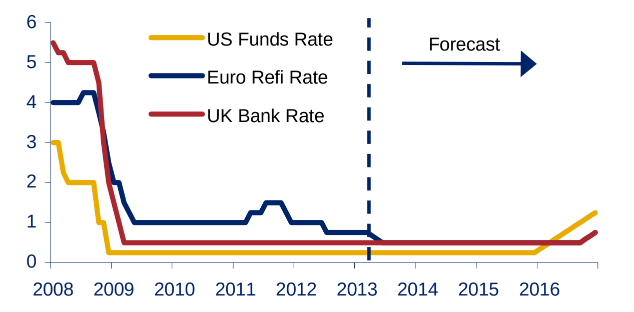
**UNITED STATES**: Not for the first time, Federal Reserve President Ben Bernanke's plea to avert fiscal tightening fell on deaf ears. March 1st came and went without any agreement on the budget, so now it's time for "the sequester" to kick in. This is a series of cuts designed to slice $1.2 tn from spending over a decade, starting with $85 bn of cuts in 2013. The Congressional Budget Office estimates the 2013 cuts will reduce growth this year by 0.6% and cost up to 750,000 jobs (click here for its excellent summary). As a result we now expect growth to be around 1.5% this year.

But the sequester is far from the end of the fiscal shenanigans. There's also the Government shutdown and debt ceiling to consider. Fortunately, the House of Representatives recently passed a bill that would allow the federal Government to continue operating beyond the current deadline of 27 March, but it still needs to progress through the Senate to become law. Despite all the fiscal uncertainty, the private sector has so far continued to make great strides forward. Job creation through H2 last year has been averaging 180k a month, with an even stronger showing in February, and surveys of manufacturing and services both hit year-long highs in February. Even so, the economy remains a long way from the Fed's targets for policy rate hikes – specifically, unemployment is still well above 6.5%. We think it will take till Q1 2016 for those conditions to be met.

**EUROZONE**: The European Central Bank (ECB) left policy unchanged at its March meeting. For now, the ECB's focus is fixing the transmission of monetary policy. There are significant cross-country differences in bank lending rates to households and companies. For example, rates on small business loans are below 4% in Germany and France, but close to 6% in Italy and Spain. This raises the concern that further monetary stimulus (e.g. a rate cut) would not be transmitted to where it is needed most – the periphery. But conditions are also challenging in the core, with the economies of France and Germany shrinking by 0.3% and 0.6%, respectively, in Q4 2012. As a result, we don't think concerns about the transmission mechanism will prevent a rate cut. Given the weak outlook (see below), we expect rates to fall to 0.5% in Q2.

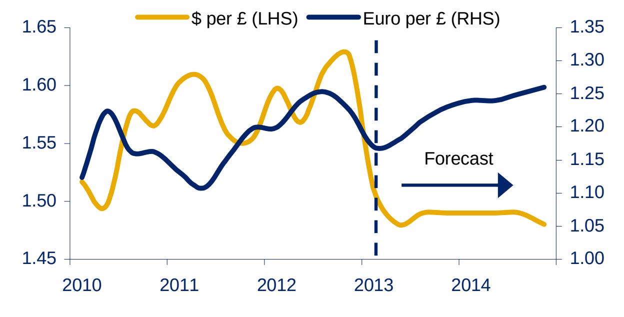
**Interest Rate Forecast (%)**

Source: Thomson DataStream, RBS Group Economics




**Exchange Rate Outlook**

Source: Thomson DataStream, RBS Group Economics

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**EUROZONE (CONT)**: The Eurozone economy will struggle in 2013. A recent forecast by the European Commission shows GDP shrinking by 0.3% this year, which is consistent with our own view. The bleak growth picture will make it harder for governments to hit their deficit-reduction targets. This could re-awaken the sovereign bond market monster, which has been sleeping since last summer thanks to the ECB's pledge to buy unlimited amounts sovereign debt if required. It also means that unemployment is to set to rise beyond the current euro-era high of 11.9%.

## Exchange Rates

The bad news just keeps on coming for sterling. Public borrowing looks set to have increased over the current fiscal year, the economy remains in the doldrums and the Bank of England seems to be having second thoughts about its decision to stop QE. Even so, the pound was able to halt its recent depreciation against the euro with the results of the Italian election weighing on the single currency. This has held GBP/EUR around 1.16 over the month – still around 10% lower than summer 2012. Against the dollar, however, sterling continued to lose ground. Indeed GBP/USD has fallen by 7% thus far over 2013 to a two-and-a-half year low (1.50).

Looking ahead there seems to be some justification for the lower GBP/USD exchange rate. The US is a number of steps ahead of the UK on the road to recovery and monetary policy messages from the Federal Reserve have spoken about putting the brakes on additional monetary stimulus. The inability of policymakers to find consensus on the fiscal front could be a banana skin – especially with the debt ceiling due to be raised in May. However, reaction to the sequester-induced spending cuts has been muted. On balance we expect GBP/USD to continue to trade around 1.50 – probably dipping into the high 1.40s in 2013. The GBP/EUR rate meanwhile looks a little low at present. The Italian election provides a stark reminder of the continued risks from the Eurozone debt crisis. Furthermore, the region remains mired in recession, which should trigger a rate cut from the ECB. On balance we expect GBP to appreciate a little against the euro in 2013, albeit not reaching highs seen during the peak of crisis in mid 2012.

| 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** | 1.51 | 1.28 | 1.17 | | 0.75 | 0.25 | 0.50 |
| **Q2** | 1.48 | 1.25 | 1.18 | | 0.50 | 0.25 | 0.50 |
| **Q3** | 1.49 | 1.23 | 1.21 | | 0.50 | 0.25 | 0.50 |
| **Q4** | 1.49 | 1.21 | 1.23 | | 0.50 | 0.25 | 0.50 |
| | | | | | | | |
| **2014 Q1** | 1.49 | 1.20 | 1.24 | | 0.50 | 0.25 | 0.50 |
| **Q2** | 1.49 | 1.20 | 1.24 | | 0.50 | 0.25 | 0.50 |
| **Q3** | 1.49 | 1.19 | 1.25 | | 0.50 | 0.25 | 0.50 |
| **Q4** | 1.48 | 1.17 | 1.26 | | 0.50 | 0.25 | 0.50 |
| | | | | | | | |
| **2015 Q1** | 1.47 | 1.17 | 1.26 | | 0.50 | 0.25 | 0.50 |
| **Q2** | 1.47 | 1.17 | 1.26 | | 0.50 | 0.25 | 0.50 |
| **Q3** | 1.46 | 1.16 | 1.26 | | 0.50 | 0.25 | 0.50 |
| **Q4** | 1.45 | 1.15 | 1.26 | | 0.50 | 0.25 | 0.50 |
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| **First expected interest rate hike:** | | | | | Q4 2016 | Q1 2016 | Q4 2016 |

| Key Central Bank monetary policy meetings for 2013 | |
|---|---|
| **Bank of England** | 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** | 4 Apr, 2 May, 6 Jun, 4 Jul, 1 Aug, 5 Sep, 2 Oct, 7 Nov, 5 Dec |