

Novus Capital Markets Research

The Sterling Debate

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The case for a stronger pound: in the aftermath of the financial crisis sterling fell by around 25% against all currencies (rather less against the US dollar, rather more against the euro and Asian currencies). This compares with the ‘successful’ post-ERM devaluation of around 15% which proved enough to stimulate strong growth in exports without producing undue upward pressure on inflation which, on the CPI definition, did not rise above 3% in the post-ERM 1990s. For Andrew Sentance the ‘excess’ devaluation this time is indicative of an overly-loose monetary policy, is a key factor in the rise in inflation to 5% or higher this year and should be reversed through higher interest rates. For David Smith the pound has overshot on the downside. The MPC should recognise this and, by talking tougher, encourage sterling to appreciate and so remove some of the uncertainty which is holding back investment decisions.

The case against a stronger pound: the case against is not against a stronger pound *per se* but against the higher interest rates that *might* get the pound higher. I say might since if higher rates damaged the UK’s already weak growth prospects, sterling might not rise in response to higher rates. So far the UK recovery has been fragile; the early signs of vigour that prompted Sentance to vote for higher rates a year ago have faded and GDP was flat over the last two quarters. While it is undoubtedly the case that the fall in sterling has added to the upward pressure on inflation, and that higher inflation is having a deflationary effect on domestic demand, I still go along with the majority of the MPC who have held off from raising rates for fear of derailing the recovery.

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The sterling debate

In a small open economy like the UK the role of the exchange rate is twofold:

- to allocate resources between the domestic and overseas sectors
- as the principal transmission mechanism between global and domestic inflation

The exchange rate, being a relative price, is a key determinant of the profitability of UK exports (or, which is the same thing, import substitution). The lower the exchange rate, the more competitive UK exports are and the more resources get allocated to the trade sector (all *ceteris paribus*). The fall in the pound since the onset of the financial crisis is a key part of the rebalancing process that is, in the Governor's words, both necessary and vital to the long-term health of the UK economy.

At the same time the exchange rate is the link between global and domestic inflation. Again *ceteris paribus*, the lower the exchange rate the more of any global price pressures will be transmitted through to prices here. The fall in the pound since the onset of the financial crisis has ensured that UK inflation is higher than the global average.

The latter insight belies the argument that since most of the inflation is being visited upon us by the global economy, in particular through record high commodity prices, there is nothing we can do about it. If there is more inflation in the global economy than we wish to import, then all we have to do is set monetary (and fiscal) policy to encourage the pound to appreciate. Broadly speaking, with a CPI inflation target of 2%, if global inflation is, say, 4% then sterling needs to rise by 2% a year and global inflation in sterling terms will be reduced to 2%, in line with the overall CPI target.

We can extend the argument by bringing in domestically generated inflation (DGI) – if DGI is above (below) the inflation target, we need less (more) imported inflation to hit the CPI target – but that is only to emphasise the point. In theory – it is more difficult in practice – we can import as much or as little inflation from the global economy as we wish by allowing the exchange rate to appreciate (depreciate) to offset (add to) whatever inflation prevails in the global economy.

The case for a stronger pound

Over the last 12 months, as the most hawkish member of the MPC, Andrew Sentance has been making the case for a stronger pound. He has argued that the strength of the global economy and the shift in economic activity to Asia are not passing phenomena and that we should plan for a world where inflation, particularly commodity price inflation, is higher than we are used to and above our inflation target.

He observes (with approval) that the MPC reacted very vigorously to the deflationary shock to the UK economy that came out of the financial crisis, cutting interest rates to record low levels and embarking on its QE programme. But then he argues that the global environment has changed and that policy should be reacting equally vigorously to what is now an inflationary global environment. One of the objectives of raising interest rates would be to deliver a stronger pound in order to insulate the UK to some extent from higher global inflation. In his final speech as an MPC member he argued¹:

The price stability objective provides the ultimate benchmark to guide how policy should respond to changes in the economic climate. So it is not right to argue, as some people have done recently, that because inflationary risks and pressures arise from the global economy they should be ignored by the monetary authorities. In the UK and in many other countries, monetary policy responds to global shocks and influences all the time. Nor is it correct to argue that inflation generated by import prices is outside the control of monetary policy. Monetary policy affects the exchange rate – which in turn can offset or reinforce our exposure to rising import prices. And the demand climate and the price expectations of firms can affect how much of this imported inflation comes through to the consumer. Yet in the UK, monetary policy has not only accommodated a large part of the recent surge in energy and commodity prices but also allowed a very significant sustained fall in the value of the pound, which has aggravated the rise in UK relative inflation relative to our peer group of other European economies.

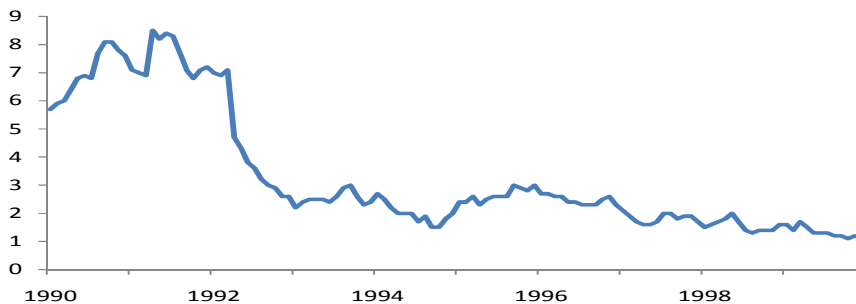
¹ <http://www.bankofengland.co.uk/publications/speeches/2011/speech500.pdf>

More recently David Smith of the Sunday Times has taken up the argument²:

The main reason Britain needs a stronger pound, of course, is that it would help control inflation and limit the extent that interest rates will need to rise to do so ... The low pound will maintain the squeeze on household incomes until fully passed through to inflation. But as long as the MPC signals it will hold off from hiking rates, sterling will not recover, and could go lower, adding to that squeeze ... It does not have to (raise interest rates aggressively but} ... It does need to recognise the advantages of a higher exchange rate in easing the squeeze on domestic demand (by reducing import prices) and allowing the economy to properly adjust. Neglecting the pound, as the Bank is doing, does nobody any good.

A key part of the argument is that sterling has fallen too far. In the (successful) devaluation that followed the UK's exit from the ERM in 1992, sterling fell by about 15%. This was enough to stimulate exports which for five years from 1994 rose by about 10% a year, nearly 50% in total, without producing a significant upward effect on inflation – CPI inflation, which was already heading lower as a result of the squeeze imparted by the ERM, remained at or below 3% throughout the post-ERM 1990s (Chart 1).

Chart 1: CPI inflation

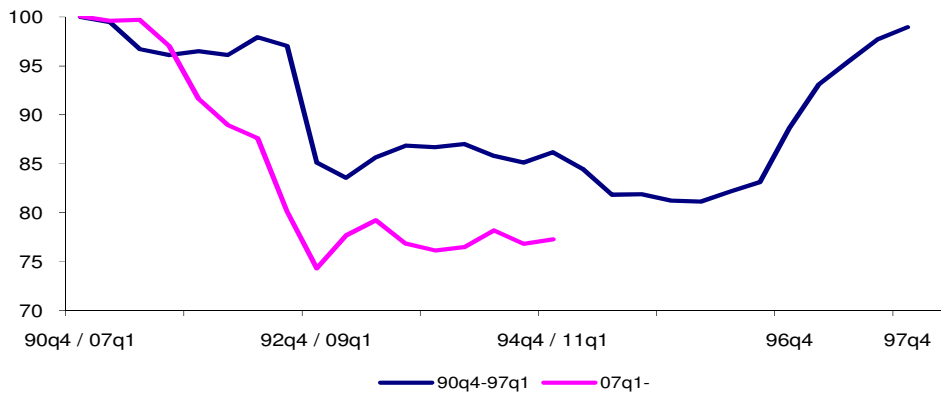


Source: ONS

² <http://www.economicsuk.com/blog/001419.html#more>

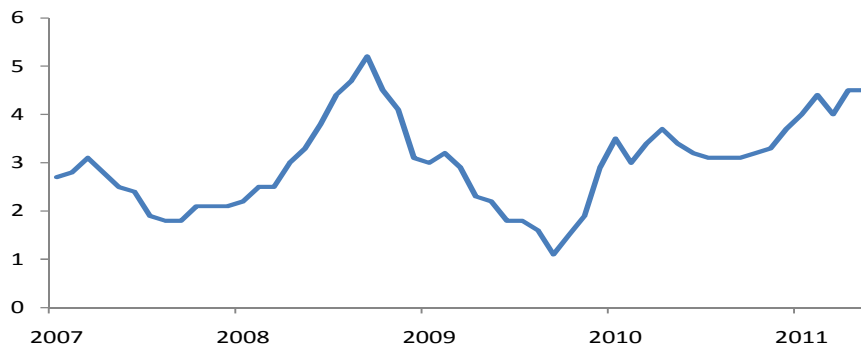
In the most recent episode sterling has fallen by about 25%, rather more than in the post-ERM devaluation (Chart 2), with so far a disappointing response from the trade sector and a much bigger effect on inflation – CPI inflation peaked at 5.2% in September 2008, fell back to 1.1% in the 2009 recession but has been trending higher over the last two years, reaching 4.5% in Apr-May of this year (Chart 3). With another round of energy price increase under way, inflation will peak at 5% or higher.

Chart 2: Sterling exchange rate (90q4 and 07q1 = 100)



Source: Bank (XUQABK67)

Chart 3: CPI inflation



Source: ONS

From this it is possible to conclude that the fall in sterling has gone further than is necessary for rebalancing the economy (even if the early results have been disappointing) and the last 10% of the fall, and the extra inflation it has given rise to, reflects excess monetary loosening, which needs to be reversed – by a combination of higher interest rates and a stronger pound.

It might even be argued that the weak exchange rate, by pushing up inflation and squeezing real incomes, is producing weak consumer demand without, at this stage, any offset from stronger net exports. Far from boosting demand, the weak pound may be holding back spending – at least temporarily.

The case against higher interest rates

It is hard to argue that a stronger pound would be ‘bad’ for the UK economy. If it had stopped falling in the summer of 2008, in particular if it avoided the trashing it took at the end of 2008 when it fell 12½% in two months, we would have lower inflation today and a peak in excess of 5% would not be in prospect. Our competitiveness would also be weaker though, since the response of exports and imports so far has been modest, the effects on UK net trade would probably have been small (so far). Rather the case against a stronger pound is that this would have to be engineered by higher interest rates and the recovery is not yet robust enough to withstand higher interest rates.

In each episode (post-ERM and as a result of the financial crisis) the pound fell along with, and in anticipation of, lower interest rates. The pound started falling in August 2007 as the first signs of the credit crunch materialised, but ahead of the first interest rate cut, which did not come until December, and fell steadily through to March 2009 by which time Bank Rate had fallen to its record low of 0.5%. The pound may also have been bid down in anticipation of the QE programme which was inaugurated in March 2009. For the last two years it has been much steadier at a little above the Mar09 lows (Chart 2).

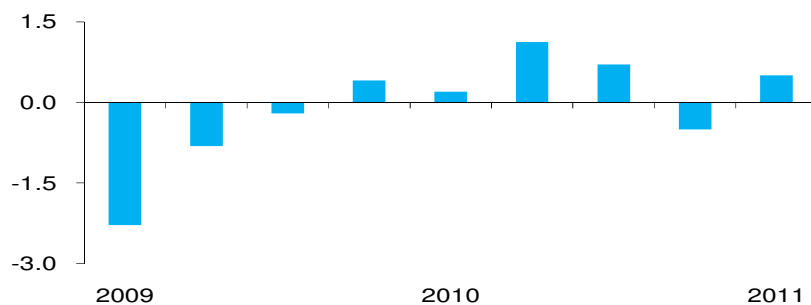
It would seem to follow from this that, for sterling not to have fallen as far as it did, either Bank Rate should not have been cut to 0.5% or that the QE programme should not have been pursued. It is hard to argue against either – Andrew Sentance along with the rest of the MPC voted for the last cut which took Bank Rate to 0.5% in March 2009 and only Spencer Dale voted against the extension of the QE

programme to £200bn in November 2009 – since they came about in response to the financial crisis and the deflationary threat it contained.

If it is hard to argue against the policies that took sterling to its lows of March 2009, then the only way to have obtained a stronger pound today is for interest rates to have been raised already. This is what Andrew Sentance was voting for starting in June 2010 ('it was appropriate to begin to withdraw gradually some of the exceptional monetary stimulus provided by the easing in policy in late 2008 and 2009'). If Sentance had had his way, then in all likelihood sterling would be stronger (though probably not much stronger) today.

At the time that Sentance made his first call for a rate hike the recovery was barely underway. The ONS had reported that GDP, having fallen nearly 5% in 2009, had risen 0.5% in 09q4 and 0.3% in 10q1 (Chart 4) with manufacturing up 2% over the two quarters, services 0.7% higher and construction down 1.4%.

Chart 4: GDP (% q/q)



Source: ONS

The MPC's forecast was that the recovery would strengthen with GDP rising 1.4% in 2010, 3.4% in 2011 and 3.6% in 2012. Inflation was forecast to peak at 3.3% in 10q2 and to be back below the 2% target by now. Since then the Bank has repeatedly had to revise up its inflation forecasts and lower its GDP numbers – to 1.6%, 1.9% and 2.5% for the years 2010-2012, a cumulative downgrade of around 2½pp.

With only two quarters of positive growth summing to 0.7% after a cumulative decline of more than 6%, Sentance's call last June for higher rates was brave. His subsequent voting record tells us he believes it was justified. He can pray in aid the inflation data though it is hard to make the case for higher rates on what has happened to the real economy where GDP growth petered out in 10q4-11q1 combined.

David Smith's case for a stronger pound is slightly different. His argument is that sterling has fallen too far and that at some stage it will recover, say, the last 10% of the 25% devaluation, bringing it more into line with what happened in the 1990s. Currencies, he observes, typically overshoot (on both the upside and the downside) and correct some of the overshooting once the interest rate cycle has turned – though note that sterling held onto its 15% devaluation from September 1992 when we left the ERM until late 1996 when it started to rise quite sharply. If on that occasion sterling undershot on the downside, there was no sign of a correction for a good four years and it took an independent MPC, which was set up in May 1997, to reverse all of the post-ERM devaluation (Chart 2).

Smith is not, as far as I know, advocating an immediate rate hike; rather, he believes the MPC's apparent indifference to the pound and the willingness of some members to contemplate further QE is preventing any recovery in the pound. He just wants the MPC to sound tougher so that markets will start to reverse some of the sterling overshoot.

He also believes that the uncertainty about exactly where sterling ends up is a bar to the investment in the trade sector that rebalancing requires. In this sense sterling weakness is counter-productive. But the future is always uncertain and sterling could just as easily stay at these lower levels (at it did for four years after the ERM) as rebound by, say, 10%. Certainly a sterling-dollar rate in the \$1.60-1.65 range is in line with historical averages even if 0.86-0.87 against the euro is historically on the weak side. In any case investment decisions always have to be made on an uncertain future and, presumably, will incorporate some margin in case sterling were to appreciate

My own view is that officials are comfortable with a weak pound. I have thought this of the Treasury since the Budget where a little-commented-on section of the Budget speech hinted to me at least that the Chancellor wants to keep sterling at low/competitive levels (But this is an opportunity for me to report that we had already decided to rebuild the UK's foreign currency reserves, which are at a

historically low level. We will purchase a range of high-quality assets – though unfortunately, with the price of gold now at record highs, we will not be able to replenish the gold reserves sold at record lows).

I think the same is true of the majority on the MPC who see a low exchange rate as key to the (vital and necessary) rebalancing of the economy. And as my votes on the Times MPC testify, I endorse the view of the majority that raising interest rates at any time in the last year would have endangered what is proving to be a fragile recovery. Of course we can (try to) do something about the weakness of sterling but only by raising rates. The case against a strong pound is not against a stronger pound *per se*; it is against what we would need to do to achieve it.

So in the short term all we can do about higher inflation is grin and bear it. In the longer term, once the MPC is confident that the recovery is here to stay, they will be able to raise rates and if that takes sterling higher so be it – or perhaps that will be the time to start adding to our foreign exchange reserves (if the Chinese can do it, so can we).

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