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What about the Sterling? Is it in crisis? Is Britain bankrupt?



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The Pound has been taking a battering in recent years, not helped by a policy of benign neglect by the Bank of England. Despite a 10% appreciation in the first half of 2009, at the end of June 2009(2) the £ERI was around 20% lower than in August 2007. At present, while currency experts focus on the plight of the dollar, it is clear that the outlook of the sterling could be just as bad, if not worse. The dollar sank to its weakest levels of the year this week against most major currencies and the pound also took a beating, hitting a four-month low against the dollar and a six-month low against the euro. Data shows that speculators are selling the British currency more heavily than at any point since records began in 1972.

Sterling's weaknesses stems from several factors, many of them similar to the challenges facing the dollar. Short term interest rates in the UK are very low and are expected to remain that way. **The UK budget deficit is set to exceed 12% of GDP in the financial year ending in March, one of the highest budget gaps in the developed world. With tax income ravaged by the recession and welfare bills rising, the treasury expects net debt to reach 80% of GDP by the middle of the next decade, more than double that it was before the downturn started.**

The Bank of England has suggested that they view the fall of the Pound as necessary, even beneficial for two main reasons:

1. Underlying Trade Deficit. The UK has been running a persistent current account deficit (importing more goods and services than exporting) for the past two decades. In the past, this trade deficit was financed by attracting capital flows. However, in the post credit crunch economy, these capital flows have fallen. Therefore, the fall in the exchange rate is necessary to rebalance trade. The UK is experiencing a fall in "the long-run sustainable real exchange rate". The fall in the Pound should help exporters and reduce attractiveness of imports.
2. Economic Recovery. Part of the Pound Sterling's weakness is due to the perception the financial / economic crisis hit the UK harder than many of our European partners. The UK banking sector is still fragile following the credit crisis and therefore, the Pound is weak to reflect the depth of recession and the likelihood UK interest rates will stay close to zero for a long time.

In addition to these factors, the other two factors weakening the sterling are:

- Large Budget deficit. Government borrowing is at record peacetime levels; very high levels of government borrowing can undermine confidence in a currency.
- Quantitative Easing is being pursued in UK more actively than elsewhere. The extent of money creation is creating a fear of potential future inflation and this undermines the Sterling.

But what is not in doubt is that the so-called "benign neglect" of sterling may be a foolish policy. The UK Government and the Bank of England hope that a fall in the value of sterling would lead to an export-led recovery, just as it had in 1992, when the pound dropped out of the European Exchange Rate Mechanism, and in 1932, when Britain left the gold standard and devalued the pound. On both occasions, British manufacturing rose to the challenge and took advantage of the low pound to sell in overseas markets. **But the difference this time is that British**



manufacturing had largely ceased to exist, having fallen to 14% of GDP even before the crisis hit. Moreover, so indebted are many British companies that the collapse of sterling may lead to a wave of corporate defaults as firms could no longer rely on foreign lenders.

Finally, the global depression and the unnecessary to the point of view of PYTHEAS re-appearance of protectionism will shrink further opportunities for foreign trade.

Britain has become over-dependent on financial services, and while there is still demand for banking services, many of the more profitable activities of the City, like hedge funds, securitization, mergers and acquisitions, and private equity deals may be destroyed by the credit crunch. PYTHEAS believes that even after the sector rebounds GDP will be smaller than it was before the crisis.

The image and reputation of British banking may become irremediably tarnished by the activities of certain banks which became a by-word for irresponsible and imprudent banking practice.

A continuing collapse of the housing market may wipe out much of the rest of the financial services sector and lead to mass redundancies in lawyers' offices, estate agents and even surveyors. Only the auction houses may experience a boom.

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