Time to squeeze the speculators out of the pound

Should we be worried or surprised by the pound's current strength? Instead of asking why the pound is so strong a more valid question may be why it was so weak? At lunch time on Friday the pound was DM:£2.75 and $:£1.62. Compare this with the end of 1995, when the pound bought 2.22 marks and 1.55 dollars. The appreciation since then has been substantial, particularly against the DM.

The rise in the pound may be a return to equilibrium. However, as it often the case in the currency markets, it has probably overshot, rising further than is justified. The pound is not far below its old Exchange Rate Mechanism (ERM) floor of DM:£ 2.78.

The scale of the pound's recent move has surprised the financial markets and shocked UK exporters. Before examining its consequences it is worth remembering what a chequered recent history the pound has had, particularly in the Nineties.

In October 1990 the Government put the pound into the ERM at the wrong time, and at too high a central rate. At that time the Bank of England had pushed the pound stronger as part of its anti-inflationary policy. Little did it realise the Government, then led by Mrs Thatcher, would choose to enter the ERM at that rate. The decision to join was largely in response to short-term political pressures and it allowed an immediate one point rate cut.

The Bank of England thought the pound's central rate of DM:£2.95 should have been lower. So too did the Bundesbank, which was never happy that it was not consulted on this matter. This sowed the seeds of the pound's eventual downfall in September 1992.

After Black Wednesday, domestic factors dominated policy making and interest rates fell sharply, bottoming at 5.25% in 1994. Policy was rebalanced in a sensible way. Fiscal policy was tightened, improving the budget deficit and restraining domestic demand, whilst lower interest rates reduced the debt problem and the weaker pound boosted exports. The economy began to recover, albeit gradually. Despite this the pound languished in the doldrums until its recovery during the last year.

There are a number of reasons for its rebound, but an important factor has been an easing of worries about policy and politics. Well after Black Wednesday, the pound continued to suffer from misplaced inflation fears that cast doubts on the appropriateness of policy. Even though there are still fears about whether recovery can continue without triggering inflation or balance of payments problems, these worries have eased substantially.

Political worries have also eased. Despite the likelihood of a change in Government, there is less concern about a shift in macroeconomic policy, as Labour is committed to reducing inflation.

As domestic economic and political fears have eased this has allowed the pound to recover, in response to stronger economic growth and continued weakness on the Continent. International investors have either sought to take advantage of the higher yields on UK assets, or some have sought to diversify their portfolios away from countries certain to be within EMU.

Also some speculative money, in search of short-term gain, has probably been attracted by the thought of higher UK interest rates. The Bank of England attributes about one quarter of the pound's recent rise to this interest-rate effect. As a result, the Bank thinks the relevance of the pound should be downplayed in the interest-rate debate. For if interest rates did not rise then, according to this view, the pound should fall. The trouble is, it is difficult to differentiate capital flows into those which are short-term, and are usually presumed to be bad, and those which are long-term, which are seen as good. As Black Wednesday showed, even so-called longer-term investors can sell a currency quickly.

The strong pound improves the chance of the inflation target being met over the next year. As a result the Chancellor has argued rates should not rise. The Bank of England is clearly not convinced, partly because it thinks some of the pound's recent rise will be reversed, but also because it regards the beneficial impact of a strong pound on the price level as a one-off impact. Their concern is still that domestic economic factors could feed inflation and thus interest rates should rise.

This highlights the policy dilemma. There is little doubt the rebound in the pound has caused problems for industry, reducing competitiveness. Import-substituting goods will suffer, as too will exports. The latest survey from the Confederation of British Industry showed a deterioration in optimism amongst exporters, weakening overall business sentiment. This has not yet shown through in the trade figures, but it will. Last week's data showed a healthy rebound in exports to the European Union in December and to the rest of the world in January.

If one views the pound's strength as a return to equilibrium then this would suggest industry needs to get used to it, and the Bank of England should view it as lessening the need for monetary tightening. But if the pound's rise is a speculative overshoot, triggered by the foreign-exchange market, then there is a strong case for the Bank of England to intervene. Such a 'bull squeeze' could repel the speculators from the pound.

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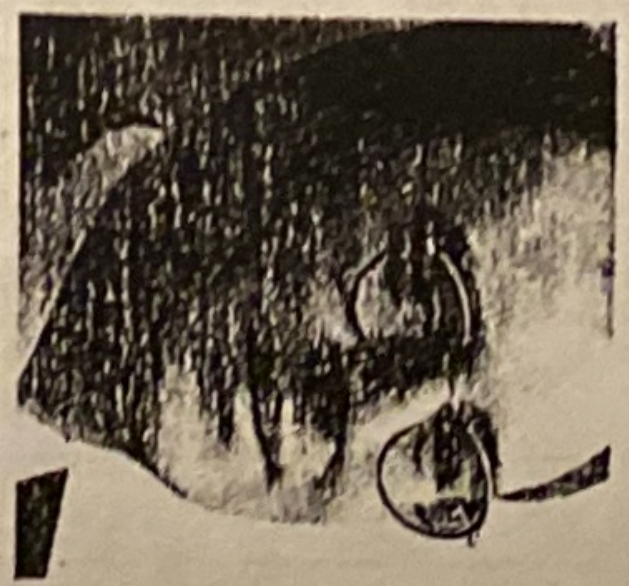

ECONOMICS WEEK

The Bank of England should intervene to halt the pound's appreciation, says Gerard Lyons