FALLING FROM GRACE

STERLING'S WEAK POSITION HAS GOT THE EURO SCEPTICS TWITCHING AND THE MARKETS WONDERING WHAT IS IN STORE NEXT. **JONATHAN LOYNES** OF CAPITAL ECONOMICS LOOKS AHEAD.

After a long period out of the spotlight, the exchange rate is once again featuring strongly in the economic debate. There are two aspects to the renewed interest in the pound. First, sterling's 10% drop against the recovering euro has arguably removed one of the largest practical hurdles to UK entry into the single currency. In old money, the pound is now at the equivalent of just 2.80 against the Deutschmark, its lowest level since 1998 and close to the bottom of its trading range in the Exchange Rate Mechanism (ERM).

Under different conditions this might have encouraged the Government to launch a concerted push towards euro entry. But such are the other hurdles to entry, not least the poor performance of the euro-zone economy and the hostility of public opinion, that even the pro-euro lobby has not used the pound's fall to argue that the time is now right to join. The forthcoming publication of the Treasury's assessment of the five economic tests for entry should confirm that the pound is here to stay for at least another five years.

GOING DOWN. Of more relevance then are the more general implications of the drop in the pound for activity, inflation and interest rates. By giving exporters a much-needed boost to their competitiveness and lifting the prices of imported materials and finished goods, sterling's fall represents a clear loosening of policy conditions. But how large is that loosening and what effect will it have on the economy?

History suggests that it could be quite powerful. The old rule of thumb supposedly used by the Treasury (although it often denied it) was that a 4% movement in the exchange rate had the same effect on the economy as a 1% change in interest rates. On that basis, the 7.5% drop in the trade-weighted value of the pound over the past six months is the equivalent of a near 2% drop in interest rates. This is a pretty big move under any conditions, but particularly so when rates are already so low. After all, a 2% drop from here would more than halve the level of rates and leave them only a whisker above the 1.25% level of rates in the US.

The models used by the Bank of England produce similarly dramatic estimates of the effects of the pound's fall. According to the minutes of the April meeting of the Monetary Policy Committee (MPC), it suggests that a 5% fall in sterling would be expected to raise inflation by between 0.5% and 1% after a year. To offset this, the Bank's models suggest that interest rates would need to rise by roughly 1%. With RPIX inflation already some half a per cent above its target, it is perhaps not so surprising that the MPC has recently discussed the option of raising interest rates as well as cutting them.

Real life rarely follows the mechanistic paths predicted by econometric models, though, and I think there are very good reasons why the impact on inflation of the drop in the pound already seen – and of any further falls to come – will be significantly smaller than these sorts of estimates suggest.

EFFECTS ON INFLATION. For a start, the inflationary effects of a lower pound are surely not independent of the conditions prevailing in the wider economy. The last episode in which sterling dropped heavily, following its exit from the ERM in September 1992, provides a clear demonstration of this. Despite a 16% drop in the trade-weighted index, RPIX inflation actually fell from nearly 4% to 2% over the next two years as the weakness of demand forced companies to absorb the resultant rise in costs and import prices, rather than pass them on to consumers. This in turn allowed interest rates to fall, not rise.

Admittedly, the economy is not as weak as it was at the time of the ERM exit, when it was still suffering from the tail-end of the early 1990s recession. Nonetheless, with GDP having grown at below trend rates for the past three years, there is still a significant amount of spare capacity in the economy or, to use the jargon, a sizeable output gap. Other things being equal, this should bear down on inflation until the gap is closed.

Even if the cyclical downward pressure on inflation is not as strong as it was at the time of sterling's ERM exit, structural downward forces are surely considerably stronger. Since 1992, the economy has enjoyed a decade of consistently low inflation, with the result that expectations for future inflation among financial markets, companies, consumers and wage negotiators have fallen sharply. This process has been further strengthened by the creation of the current monetary policy framework in which interest rates are set independently by the Bank of England to meet a clear and visible target for inflation. This has helped to anchor inflation expectations firmly to the 2.5% target.

Perhaps the most visible demonstration of the effect of these developments has come in the high street itself, where consumers' resistance to higher prices has prevented retailers from pushing prices higher, even in areas such as the clothing and household goods sectors, where sales volumes have grown rapidly in response to falling unemployment, rising incomes and the buoyancy of the housing market.

These forces are likely to grow stronger still if – as looks increasingly likely – household spending growth slows from the unusually rapid rates seen since the mid-1990s. The growth of real household disposable income has already slowed sharply, as employment growth has slowed and real wages have been squeezed. Meanwhile, the sharp falls in the stock market have dented household balance sheets and there are growing signs that the housing market is running out of steam.

If retailers have been unable to push prices higher under the favourable demand conditions of recent years, what chance do they have of passing on the higher costs associated with a drop in sterling in an environment of weakening consumer demand and perhaps even falling spending?

A VICIOUS CIRCLE. None of this is to suggest that the pound's drop has absolutely no implications for inflation at all. The fall already seen will probably have some upward effect on inflation in core high street goods sectors such as clothing and household goods, where prices have been falling, and further falls in the pound will obviously increase that effect. But my guess is that any such increase will be rather smaller than models based on past relationships might suggest, as producers and retailers are forced to absorb much of the resultant rise in costs in their profit margins.

TABLE 1
KEY STATISTICS

TRADE WEIGHTED INDEX: 99.2 vs 107.34 last Sept. – down by 7.7% since September 2002
DEUTSCHMARK EQUIVALENT: 2.80 vs 3.12 Sept 2002 – 10% drop
US DOLLAR: 1.60 vs 1.585 last Sept – up by 1.3%

Furthermore, provided that the pound's fall is accompanied by weaker activity in the domestic economy, there is a good chance that inflation in the services sector, which has previously been stubbornly strong, will soon start to ease. The growth of output in the services sector has already slowed sharply in the last couple of quarters, expanding by just 0.2% in the first quarter of the year – and it cannot be long before this has some effect on prices.

Meanwhile, some of the more erratic forces that have recently helped to push inflation higher should soon fade and, indeed, could start to work in the opposite direction. Of the rise in RPIX from its low of 1.5% last June, virtually all has been accounted for by higher house prices and petrol prices. But house prices look like they might have peaked, while petrol prices have already started to fall in response to the post-war drop in oil prices. Remember that, for the upward influence on inflation from these sources to disappear, house and petrol prices do not even have to fall – they merely have to stop rising.

The upshot of all this is that, unless the fall in the exchange rate turns into a collapse, the MPC would be wrong to let it have a major influence on its interest rate decisions. A lower pound will help to narrow the gap between inflation in the goods and services sectors, just as it will help to narrow the gap between activity in the domestic economy and the external sectors. But it will not necessarily push overall inflation higher if it is largely a reflection of a general weakening of economic activity.

Indeed, lifting interest rates higher, or failing to cut them, in response to currency traders' growing pessimism towards the economy, could even have the perverse effect of hastening the fall in the pound, potentially triggering a vicious circle of a rapidly falling exchange rate, rising interest rates and a weakening economy. Let us hope the MPC recognises these dangers.

Jonathan Loynes is Chief UK Economist at Capital Economics.
jonathan.loynes@capitaleconomics.com
www.capitaleconomics.com