Do we need to worry about the weakening pound?

Vicky Pryce

Yes, sterling has declined in the last few weeks to a six monthlow. But it is still way above the $1.09 it had fallen to after the chaos that followed the Truss /Kwateng mini budget almost exactly a year ago when the markets lost confidence in the UK, its fiscal sustainability and its currency. That was the time when yields shot up in response and the Bank of England had to intervene to buy bonds to save the pensions industry,abandoning temporarily plans to start selling the bonds it had accumulated on its balance sheet during the Covid period when it had engaged in massive Quantitative Easing. The Bank was forced to step in and start buying bonds instead. And it was only with the change of Chancellor to Jeremy Hunt and then also of Prime Minister to Rishi Sunak that the pound started to recover. And it did quite handsomely for a while, rising strongly, even touching the dizzy heights of just above $1.30 at some point.

No matter that the UK's credit rating was being downgraded by the rating agencies. A strong pound – well relatively compared to where it once was- was viewed by many as a sign of endorsement of the new PM's policies.

But no more. The allure has gone. But does it matter? The main reason is a positive one, with inflation now on a clear downward path. No longer do the markets think that interest rates will continue to rise over the next few months to reach a peak of 6.5% – or even more as was thought a little while ago. That was supporting the pound, particularly against the dollar. Indeed we had the unfortunate spectre of the Bank of England telling the UK Parliament's Treasury Select Committee that they got their inflation forecast wrong (too low) and their models seemed to be letting them down (not going back enough in the historical data it used) and then announcing the hiring of the ex Federal Reserve chair Ben Bernanke to do a review of their forecasting accuracy! Amazing to watch for those of us addicted to the parliamentary channels!

Well, it seems that models weren't that wrong after all. The path, despite some expected volatility, seems to be going downwards. Yes, petrol and diesel prices are rising again dueto OPEC production cuts and Russia's recent ban on diesel exports. And there is uncertainty about food prices as grain exports from Ukraine are once again facing restrictions. But on a yearly basis petrol prices were down by more than 30% in August. Food price inflation fell again and producer prices at the factory gate actually declined for the second month running.

So, the need for higher interest rates is reducing. However hawkish the Bank of England may try to sound about need to keep rates high for longer to stave off any inflation threats, the markets have re-evaluated the future interest path. On that basis, with rates lower than forecast, the pound looks less attractive vis a vis its peers.

What are the consequences? Inputs become a bit more expensive, but exports look more competitive. UK companies reporting results in sterling but selling large part of their goods abroad do well when those dollar or other currency denominated revenues are converted back into sterling. Their stocks have risen. And overall, a country like the UK which has seen its trading intensity drop since Brexit should be relaxed with a slightly weaker pound. We must not overstate the benefits of a weak pound on exports but overall, one could say, good news all round…

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