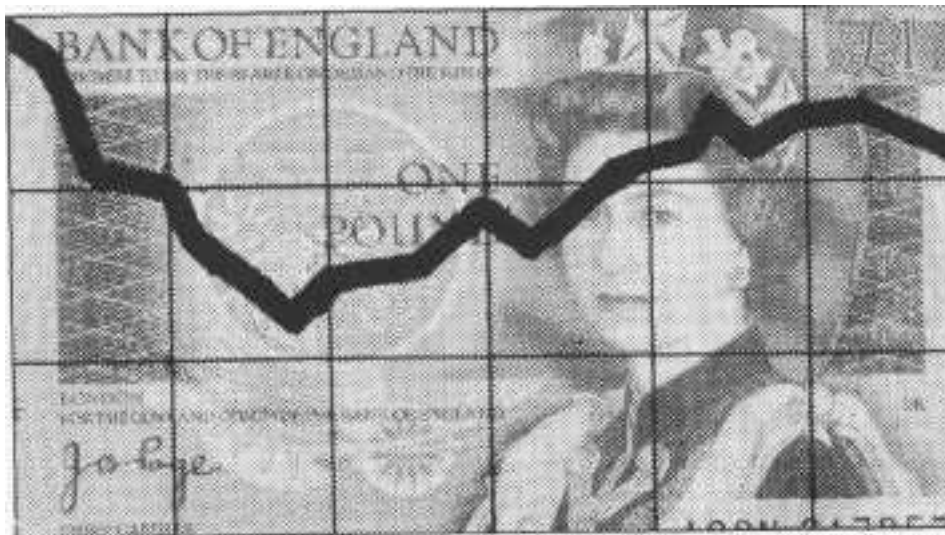


FOCUS



THE POUND

The Conservative government has recently encountered its first sterling crisis. In the course of one week in early June the pound fell dramatically on the foreign exchanges as funds were transferred into other currencies (principally the US dollar). Since such sharp movements in the past have sometimes caused an unholy scramble to get out of a currency (eg, the pound in 1976, the dollar in 1978), official circles have been watching the situation a little anxiously.

In truth, the drop in sterling has so far been modest. It has been exaggerated by the tendency of financial journalists to focus on the sterling-dollar exchange rate, which in this instance has moved further than any other. In mid-June £1 could buy \$1.95, about 20% less than in January. But the depreciation against the Japanese yen has been less than 10%, and against EEC currencies it has been so small as to be almost unnoticeable. The Bank of England's effective exchange rate index (an average of sterling rates against a large number of currencies, weighted by their share of UK trade) in mid-June was 7% below its January peak, 4% below its April level — and stood at the same value as in June 1980. Effectively, the recent depreciation of sterling has done no more than to cancel out the appreciation which took place in the second half of last year. Since this was just the last stage of an appreciation which has been going on since before the Conservatives were elected, and during that time the UK inflation rate has if anything been above the average of its major trading partners, this depreciation is so far rather a minor event. Moreover, it could be reversed if foreign interest rates fall. However, it will nudge up

the inflation rate by increasing import prices.

So the pound remains a fundamentally strong currency. The manufacturing sector will continue to find it hard to compete in world markets. This is reflected in the Treasury's forecast (made at the time of the Budget) of a 5.5% drop in export volume in 1981, and in the continuing pessimism of most other forecasting organisations. Mrs Thatcher is fond of attributing the strength of the pound to the fact that it is a 'petro-currency'. This contains a certain amount of truth, but makes no allowances for the effects of an extremely restrictive economic policy. Deflation has cut back imports, whilst strenuous efforts to control the money supply have pushed up interest rates, making Britain an attractive haven for short term capital. In addition, the money markets have been seduced by the vociferous monetarism of Mrs Thatcher into believing that sterling will remain a strong currency. All these factors together have produced a steady rise in sterling from early 1979 until the beginning of this year.

The Budget cut of 2% in Minimum Lending Rate was intended to counteract this and bring some relief to industry. The 3% fall in the effective exchange rate from January to April can be attributed to this move, which was widely canvassed in advance. It is possible that the further fall in June represents a recognition that sterling has risen too high, and that once the economy has fully adjusted to the new level the balance of payments figures would show a significant deficit. It is more likely, however, that it is a response to the tremendous rise in US interest rates, as President Reagan tries to implement a monetarist strategy similar to

Mrs Thatcher's.

Conservative policy so far has been to allow sterling to find its own level, with little interference from government, and to direct monetary and fiscal policy towards domestic objectives. This is rather a contrast with Labour policy, which attempted to steer a difficult passage between letting sterling rise too high, harming the international competitiveness of British industry, and letting it drop too low, pushing up the inflation rate. Labour anxiety on the inflation front was enhanced by the fear that an extra couple of percentage points on the Retail Price Index could be the last straw for its incomes policy. In consequence, exchange rate movements had important implications for domestic economic management. The Conservatives' supreme indifference to unemployment has until recently protected them from worrying unduly about the strength of sterling (any attempt to resist its appreciation would in any case make the task of controlling the money supply significantly harder). But we have reached the stage in the political cycle where the next general election begins to loom on the horizon. The need to present its economic policy as some kind of success (a difficult task!) may force the Government to worry rather more about what the exchange rate is doing. If it falls too much, this will push up the inflation rate, and might ditch any Tory attempt to claim victory on this score; but if it stays too high, unemployment will almost certainly go on rising. There are signs that the recent flurry in the foreign exchange markets has started to focus Conservative minds on this rather awkward dilemma.