

**With the prospect of £1=\$1 staring the Government in the face, it finally acted. But why has the pound been falling like a stone, and what will happen now?**

# STERLING TAKES A POUNDIRING



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THE LATEST STERLING CRISIS, like its predecessors, has had its elements of drama and farce. One day the pound may be dropping like a stone against the dollar; the next, although nothing obvious has changed, it seems securely stable. In the morning the chancellor is claiming no interest rate rise is necessary; by the afternoon he is recognising that there is no other way to stop the outflow of funds. The cat-and-mouse game between speculators and governments can be a source of endless fascination for a few days, as witnessed by the space which it receives in the papers and news broadcasts.

The fascination lies in the peculiar combination of absurdity and deadly seriousness involved. The apparent disorderliness and irrationality of foreign exchange markets are reflected in the very large exchange rate movements which have occurred since the advanced capitalist world stumbled its way into a floating exchange rate system over a decade ago. In 1978 the US dollar fell to ridiculously low levels; recently it has continued to rise inexorably, even though for two years or more economists have been arguing that it is overvalued and must fall. By 1980 the pound was itself massively overvalued. Now that overvaluation has been largely eliminated, and yet the downward movement continues. Exchange rate fluctuations have been much wider than the partisans of a floating rate system anticipated. They put forward a very simple argument: the activities of speculators would tend to stabilise the value of a currency because to make a profit speculators would have to buy when it was cheap and sell when it was dear. Unfortunately they overlooked the fact that the same argument could be applied to share prices, which no one regards as models of stability.

The absurdity of all this is apparent to the person in the street. The exchange

rates of major currencies have been left vulnerable to the same kind of psychological shock waves as stock markets. But the consequences for the economy are out of all proportion to the often insubstantial origins of these movements. We all feel the effects, both in the interest rate rises designed to counteract the speculation, and in the rising cost of imports which will push up the inflation rate in the months to come.

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Why has all this happened? Why is the dollar, whose average value in 1981 was 50 pence, now threatening to achieve parity with sterling?

Part of the reason is undoubtedly that Mr Lawson played his hand badly. He was not averse to a gradual depreciation of the pound, but he managed to give the impression to the markets that he was just going to sit by and watch it fall. This was an invitation to sell sterling, and of course within a couple of days the Government was forced to take dramatic steps to make clear that it did care about the level of sterling after all.

However this does not explain why sterling had been drifting downward over a couple of months before this. A major reason has been the uncertainties of the oil market. Over the decade since OPEC first jacked up prices massively, non-OPEC producers such as Mexico, Britain and Norway have greatly increased their oil production. Much of this production would have been unprofitable at pre-1973 prices. At the same time depressed demand and oil conservation measures have kept oil consumption in the major importing nations more or less static. This has forced OPEC - and principally Saudi

Arabia - to cut production back sharply in order to avoid glutting the market. But now many OPEC countries are running balance of payments deficits and have been tacitly selling oil at a discount. They are reluctant to accept further production cut-backs, and this has created speculation that the present price can no longer be held, with the possibility of a break-up in the OPEC cartel and a price collapse. This would represent a dramatic devaluation of Britain's North Sea assets and the prospective export income from them. Hence the downward pressure on sterling. The pound, in other words, has become a petro-currency.

It should be recognised that a large slice of the problem has been the behaviour of the dollar rather than of the pound. All European currencies have declined substantially relative to the dollar since 1980, so that the fall in the pound relative to other EEC currencies has been much smaller. For example, in the nine months to mid-January, sterling depreciated by 20% against the dollar but by only 6% against the French franc and 5% against the German mark. Overall, sterling has depreciated by about 20% against the mark since its peak of 1980/1, but is worth only 10% less marks than in 1978, although consumer prices have risen over the period by about 30 percentage points more in Britain than in West Germany. Thus the pound is still significantly over-valued in relation to other European currencies. This is a point which has been obscured by excessive media attention to the sterling-dollar rate rather than the wider trade-weighted index.

The continuing strength of the dollar is something which has surprised most observers. It is now about 40% overvalued as compared to its level of the late 1970s, a fact which is reflected in the massive US balance of payments deficit (with imports expanding fast because of their cheapness

in relation to US products). But the downward pressure exerted by this has been more than offset by capital inflows attracted by US interest rates. Why the capital has continued to pour in is not very clear. An important factor is that the projected very large budget deficits for the rest of the 1980s have convinced the markets that US interest rates will stay high, and that this will help to keep any exchange rate depreciation in check. Moreover the fact that a depreciation has been predicted for more than two years, but has not occurred, has encouraged a belief that a large fall in the dollar can be discounted. More recently the slowdown in the US economy has suggested that imports and tax revenue will both expand more slowly, thus improving the balance of payments and raising the budget deficit (relative to what was previously anticipated); both of these effects help to encourage expectations that the dollar will stay high.

The crisis provides the Left with an opportunity to attack the Government's free market philosophy on at least two counts. First of all, the abolition of exchange controls has removed all difficulties in the inflow and outflow of 'hot money', and this can only increase the volatility of the exchange rate. More generally, the free float which the Government has permitted since 1979 has led to fluctuations in the value of sterling which have been much greater than those experienced by the currencies linked by the European Monetary System. The evidence of the EMS suggests that a flexible method of pegging the exchange can create a fairly high degree of stability. Thus there is a good case for arguing that sterling should be pegged in a similar fashion, if not by Britain joining the EMS, then at least by a formal policy of maintaining the value of the pound within a limited range in relation to the EMS basket of currencies. This would help to insulate the exchange rate against speculative attacks, so that it would be less at the mercy of the mass psychology of the foreign exchange markets.

Secondly, the Government's laissez-faire attitude to North Sea oil output is open to criticism. The policy of non-OPEC producers has been to follow OPEC prices but without limitations on output. British oil production, in particular, has grown very fast in recent years. This policy amounts to reaping the benefits of OPEC without taking on any of the constraints of membership. This is fine so long as the demand for oil is great enough to absorb the output. But when, as now, the weak-



*The City laid waste - or in for a dollar, in for a pound . . .*

ness of the market is putting OPEC under considerable strain, and their output is far below potential, it is irresponsible for the British government to carry on as if the danger of an OPEC collapse did not exist.

Because of the high marginal rates of taxation of North Sea oil, the British people have much more to lose from a sharp drop in the oil price than the oil companies. It is true that they would gain as consumers, but since such a fall would be unlikely to be permanent the main effect would be to introduce a great deal of instability into the oil market, which would not be conducive to stabilising the exchange rate or to the orderly exploitation of the resources of the North Sea. Thus there is a strong case for Britain taking some steps to stabilise the market, for example by imposing a ceiling on its own production. The present government clearly has no intention of doing this.

The sterling crisis has not done the reputation of the Government in general, and of Mr Lawson and Mrs Thatcher in particular, any good. But its longer-term political effects are less certain. The rise in interest rates will probably do the Government little damage; people have become used to frequent changes in interest rates recently, and the middle classes have been sweetened by British Telecom profits and the prospect of income tax cuts. The inflationary effects of the fall in sterling will come through by the summer, but their significance may not be very great unless the pound falls further. The Government would certainly get worried if the inflation rate were to rise above 6% (from its present rate of just below 5% pa) since this would jeopardise its claim to have achieved a permanent reduction in inflation. But the absence of any sign of a resurgence of wage militancy is encouraging its supporters to believe that the infla-

tion rate can be kept down. In this context the miners' strike is obviously important. The present buoyancy of the stock market is based on a belief that the miners are losing, and a victory for them would clearly be a great boost to the morale of the whole trade union movement.

The issue of economic policy which is currently agitating Conservative backbenchers most is that of unemployment. They are worried that the Government could be very vulnerable on this issue at the next election. Although output has been growing for some time, and employment increased significantly in 1984, this was less than sufficient to absorb the increase in the labour force, so that unemployment continues to increase. The fall in sterling may help a little by encouraging exports, but the slowdown in the US and sluggish growth in Europe mean that the Government cannot anticipate an export boom. The growth of domestic consumption and investment may be sufficient to stop the rise in unemployment, but it is extremely unlikely that it will do anything significant to reverse it. Thus we can expect the tension inside the Tory Party on this issue to persist. It is likely to arise again in the context of the Budget, because Mr Lawson is insisting that any fiscal relaxation will take the form of tax cuts, and it is well known that these stimulate employment much less than expenditure increases because of the leakage into savings and imports.

