

# The Telegraph

## Sterling slide is painful but what we need in a global deflation crisis



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6 JULY 2016 • 9:41PM



The pound has had a spectacular fall but it is not such a bad thing in a deflationary world of currency wars

Britain faces a frightening array of economic risks if Parliament makes a mess of Brexit, but a sterling crisis is not one of them.

A weaker exchange rate acts as a shock absorber. It cushions the downturn to some degree and strengthens our buffers against deflation. Those fretting about the inflationary risk of a lower pound are stuck in a timewarp, or living on the wrong planet.

Global bond yields are touching historic lows every day and signalling a deflationary depression into the next decade. This is not like the 1930s. It is worse.

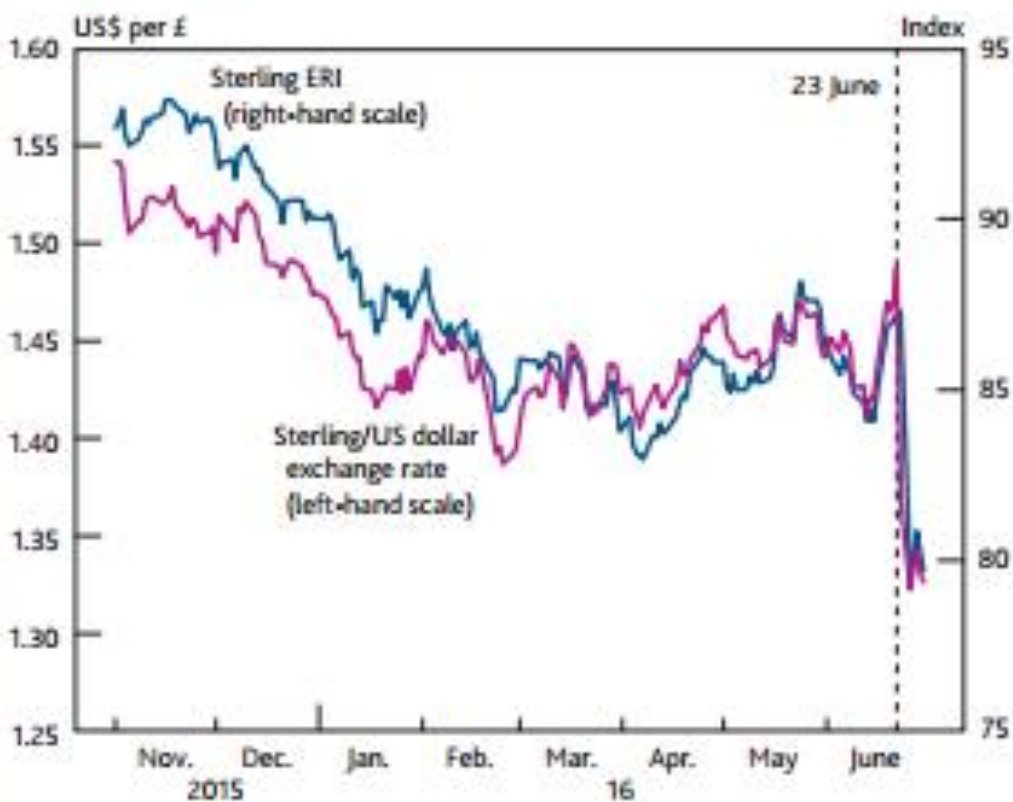
Investors are so frightened - or so short of safe debt to buy - that Switzerland can borrow for 50 years at rates below zero, Germany and Japan for 15 years, and France and Holland for nine years. Roughly \$10.7 trillion of sovereign debt and \$1 trillion of corporate debt is now trading at negative rates worldwide.

British 10-year yields have collapsed to an all-time low of 0.73pc since the Brexit vote, and 30-year yields are down to 1.58pc. This would not be happening if the bond vigilantes had the slightest concern that Britain was heading into a stagflation trap.

Countries and blocs across the G20 are trying to drive down their currencies - or prevent them rising - hoping to pass the deflationary parcel to somebody else in a beggar-thy-neighbour world.

### Chart B Sterling fell sharply as the referendum result became clear

Sterling exchange rates



Sterling's fall against the dollar is the sharpest since the Bretton Woods era, but it is less in other currencies CREDIT: BANK OF ENGLAND

As the central banks of the eurozone, Japan, Switzerland, and the Nordic states have discovered, it is very hard to devalue in these circumstances. This is the global context in which sterling is falling.

Mark Carney, the Bank of England's Governor, said on Tuesday that a weaker pound is a "necessary" adjustment and a tonic for struggling exporters. The Bank's Financial Stability Report offers a cool and clear analysis of what has gone right over recent days, and what could now go wrong. It is not seriously worried about sterling.

It warns that the epicentre of stress is in commercial property. The London market has frozen. Transactions fell by 53pc in the first quarter. Rental yields on prime West End offices have collapsed to 3.7pc, lower than the nadir of Lehman crisis.

Three quarters of small and medium-size companies rely on property as collateral for funding, so this could turn into a shock for the real economy all too easily. Six major institutions including Standard Life, Aviva, and M&G have suspended withdrawals from open-ended property funds, while Aberdeen has wiped almost £600m off the value of its fund, a sign of how rapidly the bubble is bursting.

You could argue that a weaker pound may ultimately help stabilise property prices as foreign investors move back into London in search of what is suddenly - for them - a bargain. This is what happened after the sterling slide in 2008.

Much of the stability report is surprisingly reassuring. Short-term loans to UK-based banks are 185pc of GDP, but most of this is owed by foreign groups operating in the City. Just a quarter is genuine UK exposure.

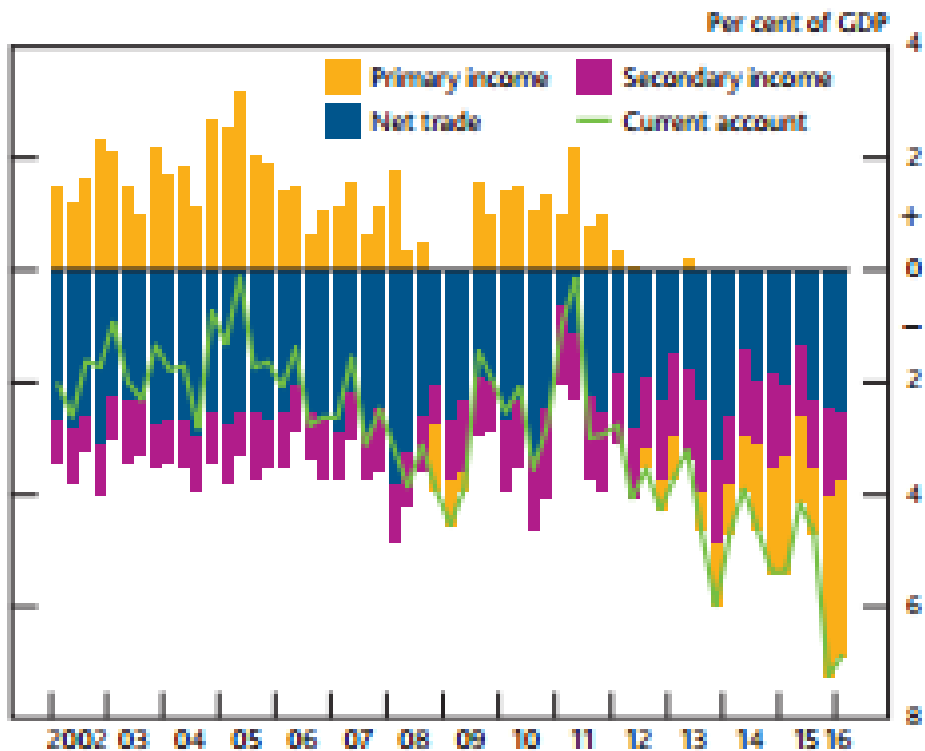
There has been no systemic seizure and no Lehmanesque stress in interbank lending. "Financial markets are doing their job. They have functioned pretty well," said Mr Carney.

As for sterling, it is trading exactly where it was in March 2013 when most people were not even aware of the exchange rate. The Bank of England's trade-weighted index has dropped to 78.5, a fall of 9pc over the pre-Brexit range, and 13pc since the start of the year. It is comparable to the devaluations of 1931 and 1992, both of which led to Gothic headlines at the time but ultimately proved benign.

The pound may have to fall yet further to restore equilibrium. The International Monetary Fund thinks it is still 3pc to 9pc overvalued even now based on the real effective exchange rate (REER) and other measures.

Or put another way, the REER has been creeping up for several years and was badly out of alignment in 2015. That is a key reason why the current account deficit ballooned to an all-time high of 7.2pc of GDP. It is not the only one, but it is the one most easily tackled right now.

## Chart A.7 The UK current account deficit is high b historical and international standards Decomposition of the UK current account<sup>(a)</sup>



Sources: ONS and Bank calculations.

The UK current account deficit hit 7.2pc of GDP late last year, the worst in peace-time history CREDIT: BANK OF ENGLAND

And tackled it will be whether we like it or not because foreign investors are no longer willing to finance our insouciant levels of over-consumption. It was never sustainable to run the economy in this fashion. Brexit has merely brought forward what was going to happen anyway - in even less favourable circumstances - in the next global downturn. Count your blessings. Yes, it will erode real incomes. These were artificially inflated.

Whether we now muddle through or spin into a deep recession depends on whether our future prime minister comes up with a plan - and very quickly - that preserves full access to European markets and the passporting rights of the City, and prevents a collapse in investment. The majority of the country wants a compromise settlement by a large margin. That is what Parliament must impose.

George Osborne has already announced a cut in corporation tax to 15pc, and his "punishment budget" will never be heard from again. It is not enough. He should heed the call of Business Secretary Sajid Javid for a £100bn investment plan to steel the economy.

It is often said that a safe exit into the European Economic Area is a non-starter because it comes with obligatory free movement of EU migrants. This is not true. The EEA council approved immigration controls for Liechtenstein in 1997 and these later evolved into a quota system. The legal precedent exists.

This is purely a political issue. If Britain and the EU wish to resolve the dispute, they can do so easily, either with the Liechtenstein model or the Ukraine association model, which allows for much the same thing. All else is posturing.

What is imperative is that Conservative Party quickly dispels the narrative propagated by the entire global media that Britain is succumbing to reactionary nativism and turning its back on the post-war international order. Both the *New York Times* and the *Washington Post* ran stories after the vote deeming it to be the death of liberal globalisation. Variants of this corrosive theme have taken hold everywhere.

It is a little irritating since all we have done is to take back our sovereign self-government from a deeply dysfunctional organisation that has over-reached badly, plays fast and loose with democracy, and is itself a major cause of the crisis engulfing Europe.

Britain is the first country to volunteer to lead one for the four NATO battalions being formed to defend the EU's eastern border in Poland, Lithuania, Latvia, and Estonia, and the Royal Air Force patrols the Baltics, two of many commitments that are a little too lightly overlooked.



RAF jets are patrolling the Baltic states, defending the EU's eastern border CREDIT: NATO

Professor Alan Riley from the Institute for Statecraft says Britain should go further to demonstrate with absolute clarity to Washington and every European capital that the country is resiling from nothing and is an ally to be reckoned with.

He wants three British armoured divisions deployed in Germany or beyond, a Royal Navy squadron in the Baltic, with a boost in defence spending to 3pc of GDP to silence all talk of retreat and entirely change the strategic balance in what is now a disarmed and paralysed Europe. I agree. We need this anyway because the world is turning more dangerous by the day.

Sir John Holmes, a veteran diplomat and EU expert, told a forum at Chatham House this week that Britain could turn Brexit into a golden era of relations with Europe "if we play our cards right and in the right spirit".

"Paradoxically, it may be easier to work together once we are free of our own paralysing fear of supranational institutions and of abandoning our sovereign right to our own policy. Once the divorce is complete, we should be able to escape the endless wrangling," he said.

Sir John asked whether anybody really believes that the status quo ante was acceptable, or whether a narrow victory for Remain would ever have resolved the matter. The answer is obviously not, and if that is the case, what conclusions do you draw?

The task for the next prime minister is to convince EU leaders that it is better for everybody to have a good British neighbour rather than a truculent British tenant. She goes to Brussels with a nuclear-armed smile.