The Telegraph

Britain should embrace weaker pound and it needs to fall further, says former BoE governor and currency guru

Global property speculators caused an overvalued pound. A big correction was necessary CREDIT: BLOOMBERG

By Ambrose Evans-Pritchard
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The slump in sterling is a blessing in disguise after years of overvaluation and helps to break the corrosive stranglehold of the financial elites over the British economy, according to a former bail-out chief for the International Monetary Fund.

“It is desirable from every point of view. The idea that Britain is in crisis or is on its knees before the exchange rate vigilantes is ludicrous,” said Ashoka Mody, the IMF’s former deputy-director for Europe and now at Princeton University.

“The UK economy is rebalancing amazingly well. It is a stunning achievement that a once-in-fifty-year event should have gone to smoothly,” he told the Telegraph.

Professor Mody, who led the EU-IMF Troika rescue for Ireland, said the pound had been driven up to nose-bleed levels from 2011 to 2015 by global property speculators and the banking elites acting in destructive synergy, causing serious damage to Britain’s manufacturing base and long-term competitiveness.

The role of the City as the unrivalled financial centre of Europe made it a magnet for speculative property flows from Russia, China, the Mid-East, and the wider world, a bubble that was further leveraged by cheap dollar credit though global banks operating in London.

“It was essentially a bank-property nexus, and the rest of the economy was left to suffer. It is stunning that just 1.4pc of all loans were going to the manufacturing sector,” he said.

The country was suffering a variant of the ‘Dutch Disease’, although in this case the problem was over-reliance on finance rather than commodities.

“Britain was borrowing 5pc to 6pc of GDP a year to buy imports and live beyond its means. The strong pound was great if you wanted to buy a Mercedes Benz of take a holiday in Spain, but the prosperity was an illusion, borrowed from the future,” he said.

Prof Mody said the pound was 20pc to 25pc overvalued in trade-weighted terms before the Brexit campaign got underway, based on classic IMF measures of the real effective exchange rate (REER). This currency distortion would have inflicted deep damage if it had been allowed to continue for another five years.

“History is going to judge that Brexit at last broke the political-economy lock of a British elite wedded to banking interests, even if it happened completely by accident,” he said.

Britain’s current account deficit was 5.9pc of GDP in the second quarter, the highest in the developed world and has been flashing warning signals for years.

While views differ on the level of overvaluation, this chronic deficit is prima facie evidence of a misalignment.

Lord King, the former Governor of the Bank of England, echoed the comments on sterling, saying the sell-off was largely welcome.

"During the referendum campaign, someone said the real danger of Brexit is you'll end up with higher interest rates, lower house prices and a lower exchange rate, and I thought: dream on.

Because that's what we've been trying to achieve for the past three years and now we have a chance of getting it."

"I don't think we should fear [Brexit]. It's not a bed of roses, but nor is it the end of the world," he told Sky News.

Prof Mody said ‘fair value’ for sterling is around $1.10 against the US dollar, implying a further fall of around 11pc. “There is some likelihood that it is will overshoot and reach parity, but my reaction as a policy-maker is to ask ‘what’s the big deal’,” he said.

The latest sell-off was triggered by thetough Brexit rhetoric from Theresa May and top ministers at the Tory party conference last week, dashing hopes for a compromise option that includes passporting rights for the City and full access to the single market.

Morgan Stanley has raised the likelihood of a ‘hard Brexit’ from 55pc to 70pc, but said it is still far from clear whether the Prime Minister can really persist with the current line given the bitter divisions in the country.

The US bank suggested that there may be a “technical fix” that would allow some form of shared decision-making with the EU without Britain having to submit to the European Court, as well as a fudge on free movement of workers through so-called ‘economic work visas’.

David Meier from the Swiss bank Julius Baer said the conference rhetoric should be taken with a pinch of salt. “We have our doubts that UK officials really believe in what they are signalling.

A hard Brexit with loss of single market access would severely damage the economy and cause many firms to relocate into the EU market. We think Mrs May is simply rattling her sabre," he said.

The Chancellor, Philip Hammond, has so far kept a stiff upper lip. "Markets go up and down, markets respond to noise," he said, following the 'flash crash' last Friday.

"The important thing is to look through the movements of currency markets and short-term movements in sentiment," he said.

Simon Derrick from BNY Mellon said there is almost nothing they can do about it anyway – short of changing their Brexit strategy – since the Bank of England's total foreign reserves are just $173bn. This is petty cash in global finance.

Any attempt to defend sterling by raising interest rates would risk aborting the recovery, and might prove self-defeating in any case. "There is no line in the sand," he said.

Devaluations are never a panacea - and can have nasty side-effects - but in the short-run they act as a macro-economic stimulus and help the cushion economic shocks.

A weaker currency has lost its ability to frighten in a deflationary world where most of the major advanced states or economic blocs are trying to drive down their exchange rates to break out of the liquidity trap. Britain has inadvertently stolen a march in an undeclared global currency war.

For the fragile eurozone economy, the opposite dynamic is playing out. The pound is one of the largest components of the euro's trade-weighted index, and the 20pc fall since late last year has the side-effect of further tightening the deflationary noose.

The exchange rate has now fallen so far that most eurozone exporters selling into Britain can no longer absorb the currency effect by shaving their profit margins. They increasingly face the risk of declining sales and market share.

Prof Mody said eurozone leaders may be on thinner ice than they care to admit. "They are in a debt-deflation cycle, and it is self-reinforcing," he said.

French president Francois Hollande has now openly stated that his desired policy is to "threaten" Britain and make the country "pay a price". The more he succeeds, the more painful the blowback into France.