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Pound Set for Pain as Cuts Push King to Print Money (Update1)
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(Updates prices in second, fifth and 12th paragraphs and adds analyst comment in 16th.)

By Lukanyo Mnyanda and Stephen Morris

Oct. 25 (Bloomberg) -- The only major currency rivaling the dollar's decline since July is the pound, and foreign-exchange strategists say the worst is yet to come for Britain's legal tender.

Sterling has depreciated 4.87 percent against a basket of the nine other most-traded currencies, including last week's 1.29 percent drop. Strategists are the most pessimistic on the pound versus the euro since the ruling Conservative-Liberal Democrat coalition came to power in May, according to data compiled by Bloomberg.

The decline suggests investors are losing confidence in Prime Minister David Cameron's ability to restore growth while promising the deepest spending reductions in British history to shrink the biggest deficit in the Group of 20. His 81 billion pounds ($128 billion) of cuts through 2015 will force Bank of England Governor Mervyn King to print cash through so-called quantitative easing to prevent a new recession, overwhelming demand for sterling, according to UBS AG.

"There's definitely more weakness to come," said Hans- Guenter Redeker, global head of currency strategy in London at BNP Paribas SA. "The fiscal consolidation is going to hit the economy at a time when it's slowing. Under these conditions, you need to have loose monetary conditions and that weakens the exchange rate."

Redeker predicts sterling will drop to $1.40 by June. The currency traded at $1.5744 as of 12:37 p.m. in Tokyo.

## Sell the Pound

UBS, the second-biggest currency trader after Deutsche Bank AG, recommended on Oct. 21 its clients sell the pound, especially against the Swiss franc, Australian dollar and Norwegian krone. Morgan Stanley strategists said it may weaken to 93 pence per euro from 89.09 pence today should the recovery slow further or Bank of England policy makers signal more credit-easing measures.

This week's report on third-quarter gross domestic product "will be key in the Bank of England's decision of whether to undertake QE or not in November," London-based Morgan Stanley strategists Tim Davis and Calvin Tse wrote in an Oct. 21 report.

Britain's expansion slowed to 0.4 percent in the period, from 1.2 percent in the three months ended June 30, according to the median estimate of 35 economists surveyed by Bloomberg. GDP will increase 1.6 percent this year and 1.9 percent in 2011, another survey shows. Germany will grow 3.3 percent in 2010 and 2 percent next year, while U.S. GDP will expand 2.7 percent and 2.5 percent, separate surveys show.

## Counting on Exports

A depreciating pound may help U.K. exports at a time when countries from China to the U.S. and Japan are seeking to boost international sales through weaker exchange rates.

At their meetings this past weekend, G-20 finance chiefs sought to calm trade frictions by pledging to avoid weakening their currencies to boost exports and let markets increasingly set foreign exchange values. The group agreed to “move towards more market determined exchange rate systems that reflect underlying economic fundamentals and refrain from competitive devaluation of currencies,” finance ministers and central bankers said after talks in Gyeongju, South Korea.

The Centre for Economics and Business Research said Oct. 17 the Bank of England will expand its quantitative easing asset- purchase plan by 100 billion pounds, adding to the 200 billion pounds policy makers bought starting in March 2009. King signaled Oct. 19 he may be open to more buying, saying in a speech in Dudley, England, that some measures of U.K. inflation are “extremely subdued.”

## Diverging Policies

The pound’s slide since July 30 compares with a drop of 5.2 percent for the dollar, according to Bloomberg Correlation- Weighted Currency Indexes. Since climbing to $1.6107 on Oct. 15, the strongest level versus the greenback since Jan. 29, sterling has dropped 2.3 percent, and weakened 2.2 percent against the 16-nation euro.

While the Bank of England weighs whether to add stimulus, the Frankfurt-based European Central Bank is exiting emergency measures that followed the collapse of Lehman Brothers Holdings Inc. in September 2008, which sparked the worst global financial crisis since World War II.

The ECB is allowing supports to expire, Executive Board member Juergen Stark told the Die Welt newspaper on Oct. 20.
German Chancellor Angela Merkel said that day governments must find an “exit strategy” from emergency spending.

## Swelling Deficit

Efforts by Cameron, 44, and Chancellor of the Exchequer George Osborne, 39, to reduce the 156 billion-pound deficit initially helped the pound by reassuring investors the risk of Britain losing its AAA credit rating was receding at a time when the euro area’s sovereign-debt crisis brought Greece to the brink of default. The pound rose 6.49 percent between March 10 and Aug. 11, based on Bloomberg Correlation-Weighted Indexes.

The U.K.’s spending cuts are “insane” and the pound will slump to below $1.40 as early as this year, John Taylor, chief executive officer of FX Concepts Inc., told the Telegraph newspaper.

The cuts are aimed at narrowing the deficit to 2.1 percent of GDP in the 2014-15 fiscal year from the government forecast of 10.1 percent this year. Debt interest costs would fall by more than 5 billion pounds by 2015.

## ‘Raising Rates’

“The U.K.’s fiscal policy is going to be tighter than anyone else’s, and therefore there’s much less reason to expect any tightening of monetary policy even if there is some sort of global recovery," said Adrian Schmidt, London-based foreign- exchange strategist at Lloyds Banking Group Plc in London.

Schmidt said the pound may weaken to 95 pence per euro this year. "The ECB will be raising rates before the BOE," he said.

Since raising their fourth-quarter predictions for the pound to as strong as 80 pence per euro in July, a level not seen since November 2008, analysts now see the currency trading at 86 pence by year-end, according to the median forecast in a Bloomberg survey. In the past year, the median fourth-quarter estimate for sterling versus the dollar has fallen more than all but four of 60 pairs tracked by Bloomberg.

Fitch Ratings said Oct. 20 the budget cuts were consistent with the U.K.'s top AAA credit rating. With the inflation rate above the government's 3 percent upper limit since March, bulls say the Bank of England may avoid more quantitative easing.

## 'Like the Pound'

"We like the pound relative to the dollar," said Monica Fan, London-based senior currency strategist at State Street Global Advisors, which oversees $83 billion. "King's recent statement, which the market took as an endorsement of another round of QE, took a bit of the shine off, but the pound remains undervalued against the dollar and the government's fiscal consolidation will provide support."

The Bank of England risks stoking inflation with little benefit to growth should it expand bond purchases, former policy maker Kate Barker said on Oct. 18 in London. Andrew Sentance, another central banker, has said since June that the central bank should raise interest rates to tame inflation.

The 10-year breakeven rate, a measure of inflation expectations, reached 2.856 percentage points last week, the highest level since July 5. The rate increased from 2.476 percentage points on Aug. 31, the least this year.

Policy makers may favor a weaker pound to keep Britain's exports competitive, said Robin Marshall, a director of fixed income at Smith & Williamson Investment Management in London, which oversees about $20 billion.

## 'Weak Currency'

"It's helpful for exports to have a weak currency," he said. "You could argue that in this environment of competitive devaluations there's something to be said for getting your retaliation in first."

History suggests sterling's losses will be sustained while Osborne implements cuts that are bigger than those announced by Geoffrey Howe when he was Margaret Thatcher's chancellor in 1981, according to UBS. The pound lost 20 percent against the dollar that year and weakened the following three years.

"The main parallels between now and the early 1980s are that fiscal policy is clearly being tightened, the economy is weak, so the Bank of England may have to respond," said Mansoor Mohi-uddin, global head of currency strategy at UBS in Singapore.

"The currency market is beginning to focus on the downsides of fiscal tightening."

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