Brexit

Will UK economy be turbocharged by sterling fall?

Economists say Britain unlikely to repeat export boom of 25 years ago after ERM exit

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Chris Giles, Economics Editor SEPTEMBER 13, 2017

A decade has passed since Northern Rock went cap in hand to the Bank of England for emergency funding at the start of the financial crisis. It is a quarter of a century since sterling was ejected from the European exchange rate mechanism.

Both anniversaries, on Thursday and Saturday respectively, mark events which led to a significant drop in the value of sterling.

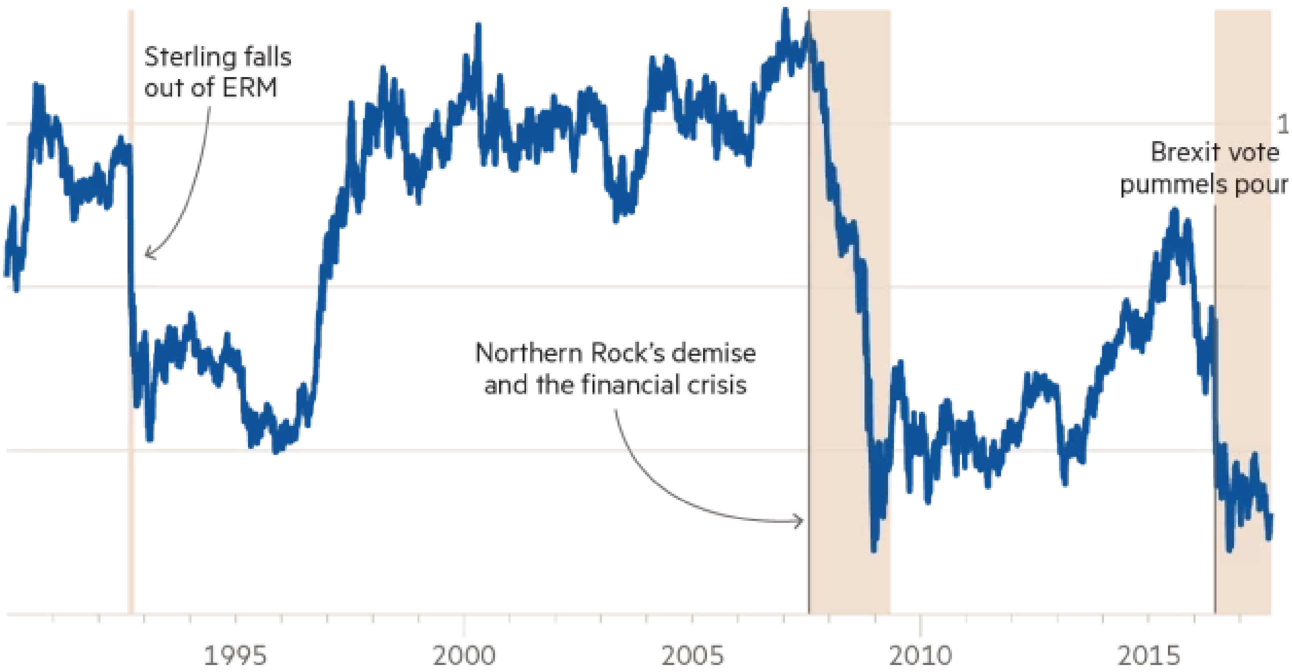
After a third significant depreciation last year when the pound was pummelled by the UK vote to leave the EU, how much guidance does history provide for Britain's future? Will sterling's latest decline signal the start of a long period of prosperity, following the script of 1992, or a series of disappointments, as Britain suffered after 2007?

On 16 September 1992, strenuous efforts by John Major's government to keep the pound in the ERM at its rate of 2.95 Deutsche Marks to the pound failed. When investors kept dumping sterling even after the Treasury raised interest rates to 15 per cent, people knew the game was up. The government's credibility and economic policy was in tatters. People feared the worst.

Sterling fell 15 per cent over the next few weeks, but instead of nursing a devalued economy, the event gave room for Britain to boom.

Sterling has come crashing down three times in 25 years

£ rate (Jan 2005 = 100)



Source: Bank of England

The economic growth rate averaged 2.9 per cent over the next five years and inflation did not materialise. A weaker pound helped export volumes increase at double digit rates, eliminating Britain's trade deficit by 1995 — the first time this had happened in a decade. "The economic effects were entirely benign," says Norman Lamont, who was chancellor at the time of sterling's exit from the ERM.

The more recent anniversary is much less encouraging. Queues of Northern Rock customers began forming outside some of its branches on 14 September 2007 as people worried about its future sought to withdraw their deposits. Investors soon ditched sterling after the run on Northern Rock showed Britain to be close to the centre of a gathering global financial crisis. By the end of 2008, sterling had plunged more than 25 per cent against the currencies of Britain's main trading partners.

The BoE hoped for a rebound similar to the mid-1990s, but was repeatedly confounded.

Norman Lamont was chancellor, pictured here in 1992, at the time of sterling's exit from the ERM © Times/Rex/Shutterstock

Growth failed to bounce back from a deep recession and moved to a weaker path. Inflation persistently exceeded the central bank's 2 per cent target, which served to squeeze households' incomes, and a cheaper currency did little to boost exports or curb imports. Britain's trade deficit hovered around 2 per cent of national income and in 2010, three years after the depreciation, was worse than in 2007.

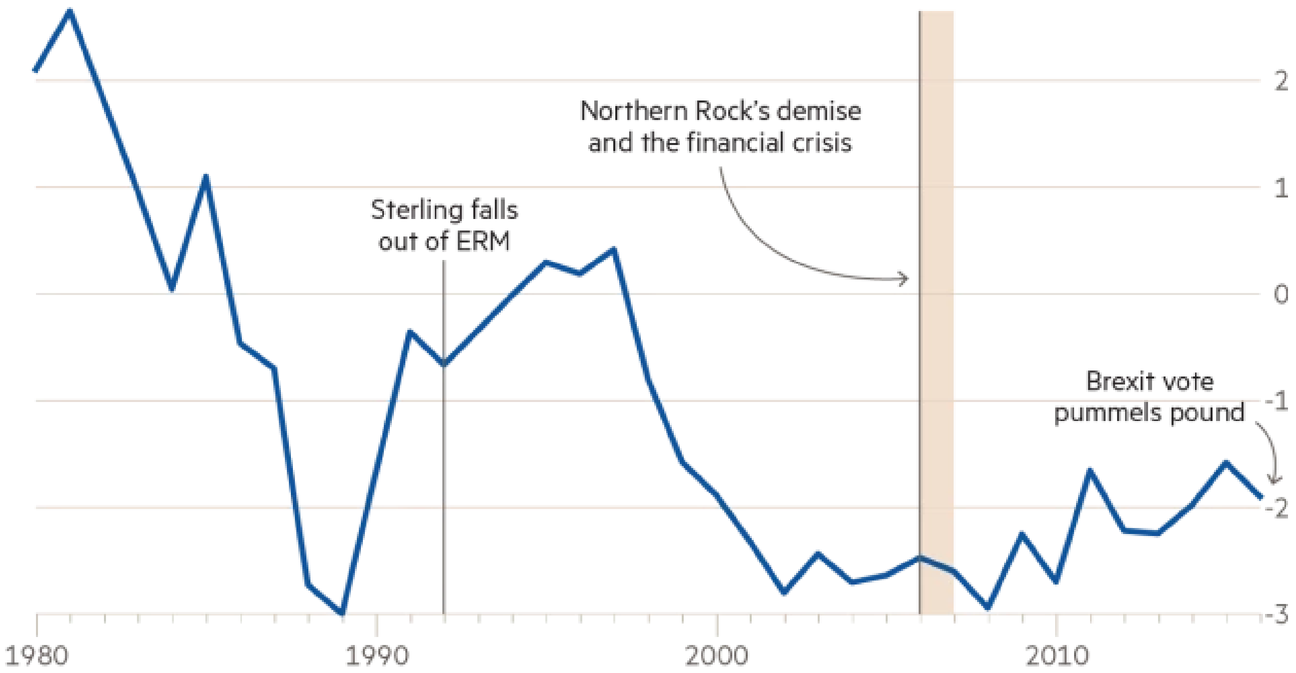
Sterling's falls in 1992 and 2007 therefore give cause for both hope and fear. To date it is the pessimists that are winning the battle of the data.

After the Brexit vote, growth was strong but then faded as rising import prices stoked inflation and hit households' incomes. The latest official figures on Tuesday showed consumer price inflation was 2.9 per cent higher in August than one year earlier, with wage growth running at little over 2 per cent.

The economy's trade performance has shown no upside from the fall in sterling yet, despite business surveys showing exporters almost as happy as they have ever been. In the second quarter of 2017, the trade deficit reached £8.9bn, compared to £7.8bn one year earlier, as the volume of imports grew just as fast as the (smaller) volume of exports.

Britain's trade performance has failed to respond to sterling weakness since 2000

Trade in goods and services as a share of GDP (%)



Source: ONS
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Samuel Tombs, economist at Pantheon Macroeconomics, says: "Sterling's depreciation has hurt consumers, by fuelling inflation, more than it has helped exporters."

Exporters of goods have tended to raise the sterling price of their products, in a move that boosts margins rather than market share. Meanwhile the volume of Britain's services exports has risen little in response to sterling's fall as they are less sensitive to price changes.

And with uncertainty over Britain's future trading arrangements after Brexit, few companies have been willing to invest in new plant and equipment to spur exports.

Queues of Northern Rock customers began forming outside some of its branches on 14 September 2007 © Tom Palmer/PA

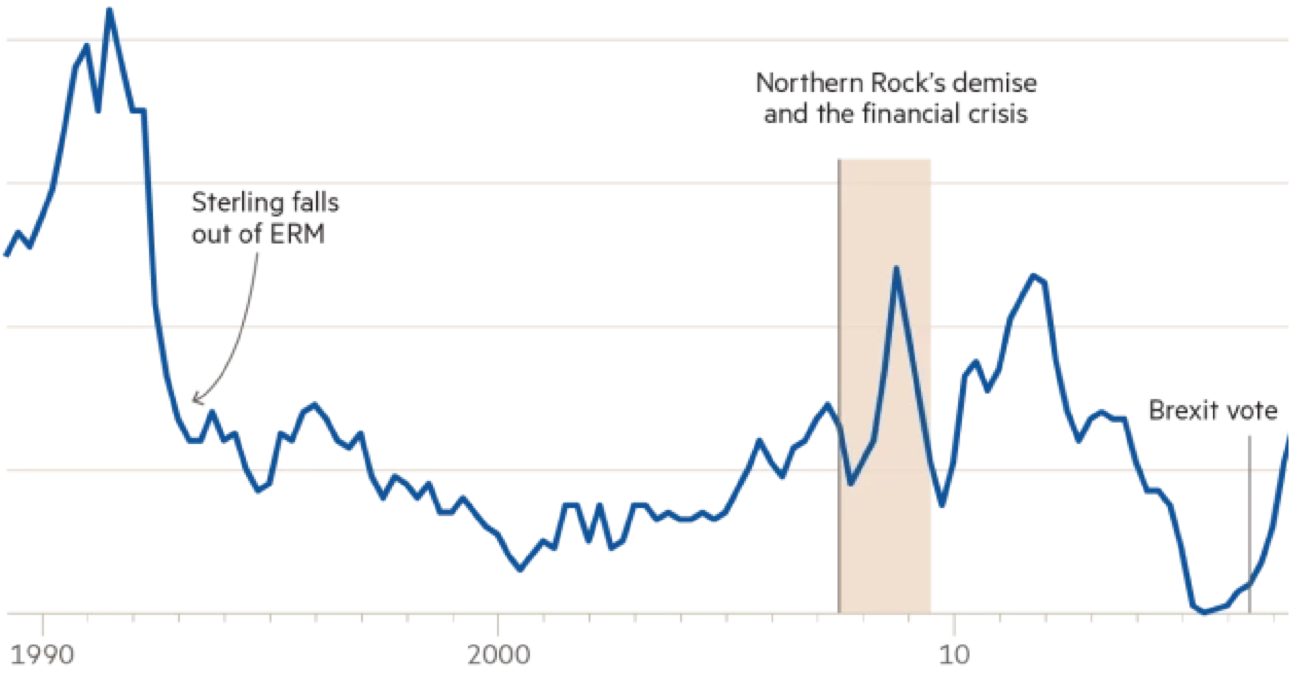
While these factors give economists cause to be cautious about the effects of sterling's 16 per cent decline against the currencies of the UK's main trading partners since the start of 2016, many believe there are more fundamental forces at work which should quell optimism about Britain's economic future with a cheaper currency.

In a major speech in 2015, Kristin Forbes, a former MPC member, noted that "a greater consideration of why an exchange rate moves could improve our understanding of its effects".

This message has been taken on board by most economists. If the cause of a currency depreciation is the end of an artificial straitjacket, they think significant benefits are likely to flow, but such gains do not materialise if the pound has fallen because the UK's trading strength is expected to be fundamentally weakened by Brexit.

Inflation has been more responsive to sterling weakness since the millennium

UK CPI (%)



Source: ONS
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The latest Treasury round-up of independent forecasts by economists show this new thinking at work.

In August 2016, economists expected net trade to contribute 0.5 percentage points to growth in 2017. But they now think trade's contribution will be zero. And over the five years starting in 2017, the total contribution of trade to the UK economy is predicted to be not much more than nothing, at 0.2 percentage points.

In any case, argues Stephen King, economist to HSBC, the buoyant British economy of the 1990s is falsely credited to the depreciation in 1992. "When the UK left the European exchange rate mechanism in 1992, sterling's decline may have provided some support but the greater benefit came from much lower interest rates, not a much weaker exchange rate," he says. "Given where interest rates are today, there's no chance of a repeat performance."

A quarter of a century on from the ERM debacle, economists have no confidence that the latest depreciation of sterling will provide a boom. While most hope the economy can perform better than in the years after Northern Rock, the outlook is one of hard graft for households, rather than a 1990s-style export revival.

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