Funding the deficit: the big test for the pound

By Buttonwood
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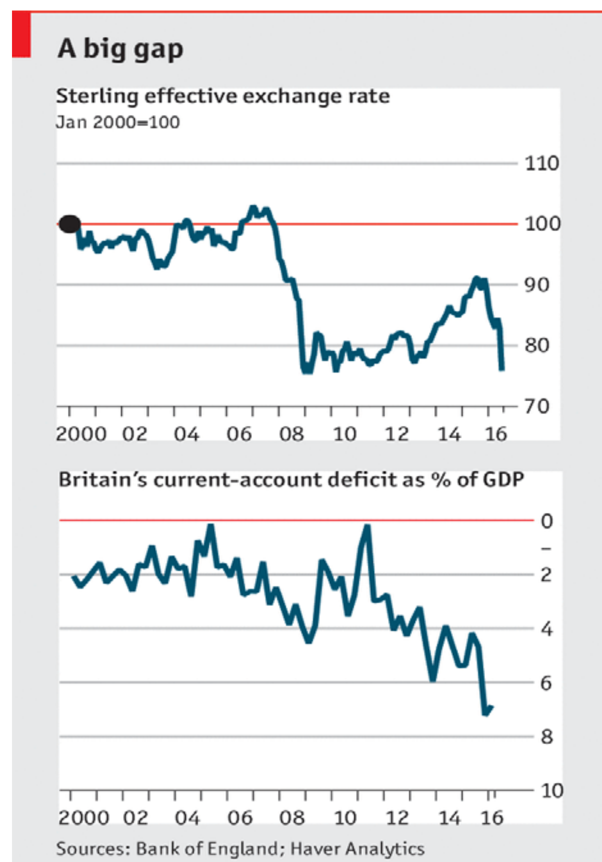
The pound has been the biggest post-Brexit casualty in the financial markets. It has fallen from almost $1.50 to around $1.30 against the dollar; less so against the euro which itself has been dragged down by Brexit worries. The immediate impact for British citizens is a cut in their standard of living; it costs more to buy goods from abroad, whether it be imported commodities or foreign holidays.

Of course, currency depreciation can be a very useful tool for countries when they have become locked in to an overvalued exchange rate. Many people will recall Britain's departure from the Exchange Rate Mechanism in 1992 when the economy perked up quickly and the inflationary impact was limited. But the circumstances were very different; interest rates were 12% and were brought down rapidly while there was a lot of spare capacity in the economy (unemployment was 10%). Now interest rates are just 0.5% and unemployment is 5%.

The big question, as David Bowers and Ian Harnett of Absolute Strategy Research explain, is the British current-account deficit. At around 7% of GDP, this deficit is not just a peacetime record, it is bigger than the shortfalls seen in World War One (but not WWII). This means that Britain has to attract foreign capital; it has been very successful in doing so via foreign direct investment (FDI). But that was, in large part, because of Britain's place as part of the EU. Last year, a survey by Ernst & Young reported that:

> *With 72% of investors citing access to the European single market as important to Britain's attractiveness, the referendum has the potential to change perceptions of Britain dramatically, posing a major risk to FDI. Our survey indicates that 31% of investors will either freeze or reduce investment until the outcome is known.*

All this has now been thrown into doubt. Of course, one element of the Brexit campaign argued that Britain could become more open to international investment outside the EU; a kind of Singapore of Europe. However, as this blog pointed out before the vote, this camp sat uneasily with the more nativist, anti-globalisation and anti-immigration side of the campaign. Until the outcome of the post-Brexit negotiations become clear (and the talks may not even *start* until next year), investors may hold back. Indeed, when it comes to the property market (one source of FDI), there are signs that investors have already done so.



As with everything in economics, things can get back into balance at the right price. The pound can fall so that British assets are so cheap that they seem attractive. But ASR argues this may require a prolonged decline to cheap levels; they estimate that fair value for the pound/dollar rate is around $1.42. Eliminating the deficit could require the pound to fall to parity with the dollar.

The pound did get almost that low in the mid-1980s (that was largely down to a soaring dollar, rather than any great British problems). Such a fall would drive up inflation significantly, squeezing living standards (the problem that may have inspired some voters to back Brexit in the first place).

It would, of course, be good for exports. But as the chart shows, Britain has already seen one big depreciation in the pound since 2000. It narrowed the current-account deficit for a while but the effect was short-lived. Recent evidence does not show that currency depreciations lead to a big gain in market share for exporting nations. The first issue is that world trade is growing fairly sluggishly. The second, as ASR points out, is that companies may decide not to cut their prices in foreign currency terms but to take the higher foreign currency receipts (in domestic currency terms) as extra profit.

A third issue is that globalisation means that business is conducted through "value chains", in which products are assembled or distributed in many markets. These chains take time to assemble and companies are unlikely to unpick them because of currency shifts. This paper published on Vox explains that:

> *By disentangling the impact of exchange rate changes on trade results, we have shown that the underlying assumption of the 'currency wars' discussion – that devaluations bring about substantial export gains – may be severely flawed. Non-price/non-exchange rate factors often appear to explain the lion's share of export outcomes, and this is particularly the case when exports are measured in value-added terms.*

Indeed, it is worth noting that a deficit can fall in two ways; a rise in exports or a decline in imports, thanks to a collapse in domestic demand (as in 2009). That route tends to be more common. But it won't be what voters thought they were getting as they clearly didn't believe the warnings of economists before the vote.