



## Economics Weekly

28 September 2009

### Is the fall in sterling good or bad news?

Judging by the fevered headlines surrounding the fall in the UK's exchange rate over the past couple of weeks, one might imagine that sterling was on the verge of a currency crisis. We argue that it is not. We examine the reasons for the recent decline in the UK currency and assess its prospects going forward. Our conclusion is that, far from being a cause for concern, the depreciation is not only desirable, but essential if the UK is to undergo a successful rebalancing away from domestic demand towards net exports over the coming years. Indeed, judging by the comments made by Bank of England Governor Mervyn King last week, and a recent article published in its latest Quarterly Bulletin, this view appears to be shared by the Bank of England.

**Table 1: Comparison of nominal and real sterling exchange rates**

	Nominal exchange rates		
	GBP/USD	GBP/EUR	GBP/JPY
Current value	1.62	1.13	151.07
Average since 1991	1.67	1.40	194.07
% deviation from mean	-2.99	-18.95	-22.16
Standard Deviation (S.D.)	0.17	0.15	31.80
No. of S.D. from mean	-0.29	-1.81	-1.35
	Real exchange rates (Jan 05 = 100)		
	GBP/USD	GBP/EUR	GBP/JPY
Current value	85.11	82.26	92.56
Average since 1991	91.70	100.99	91.88
% deviation from mean	-7.19	-18.55	0.74
Standard Deviation (S.D.)	8.18	31.80	16.33
No. of S.D. from mean	-0.81	-0.59	0.04

#### Are the recent movements in sterling really that large?

Firstly, it is worth assessing whether recent movements justify some of the hyperbole in the press. We do not believe so. Since early September, sterling's trade-weighted index has fallen by around 4.5%, primarily pulled lower by a 4% drop against the US dollar, a 5% fall against the euro and a 5.5% fall against the yen. Although the recent falls have been relatively large, they are not unusual for a historically volatile currency such as sterling. To put the recent decline into perspective, the average one-month standard deviation of the UK's trade-weighted index over the past five years has been 2.2%; for £/\$, £/€ and £/¥ it has been 3.3%, 2.4% and 4.9%, respectively.

#### Is sterling undervalued?

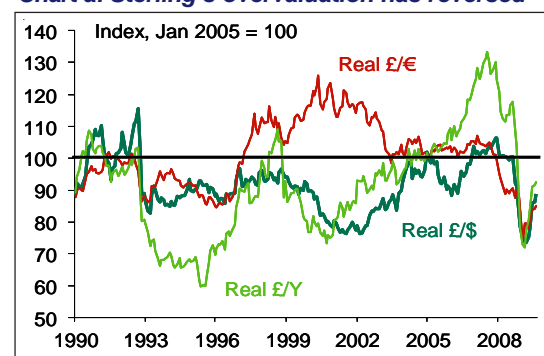
The latest decline brings the cumulative depreciation of sterling's trade-weighted index to 26% since it hit a peak in January 2007. Nonetheless, contrary to conventional wisdom, the UK currency does not appear to be particularly undervalued at current levels, at least against the major currencies. Table 1 shows some key statistics of the major sterling crosses in both nominal and real terms. In nominal terms, sterling is only 3% away from its average value against the US dollar since the early 1990s, well below one standard deviation from its mean. Against the euro and yen, however, the undervaluation appears more substantial, with £/€ and £/¥ 1.8 and 1.4 standard deviations below their 1990-2009 means, respectively. On the face of it, this suggests that sterling could be due a bounce against these currencies. But, when account is taken of the relative movements in consumer prices, these undervaluations disappear.

The reason for this is the divergence that has occurred in relative consumer prices since the early 1990s. In the UK, the price level has risen faster than it has in the eurozone and Japan. Other things being equal, the rise in prices has made the UK economy less competitive as sterling's real exchange rate has strengthened. The shift has been particularly noticeable versus the yen, given Japan's deflation over the past decade. Against the yen, sterling is currently slightly above its average in real terms.

#### Sterling is susceptible to further weakness...

The fact that sterling's real value against these crosses does not appear particularly stretched suggests that there is clearly scope for sterling to fall further. Indeed, we suspect the fall in sterling's nominal and real exchange rate over the past couple of years has done little more than reverse what was previously an unsustainable overvalued position (see chart a). Indeed, given the UK's persistent current account deficit, the conclusion is, perhaps, that sterling has not fallen enough.

**Chart a: Sterling's overvaluation has reversed**



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# 28 September - 5 October 2009

Date	United Kingdom	United States	EU-16
Mon 28			<b>German CPI (07:00) (prel)</b> Aug +0.3% Y-O-Y -0.1% Sep (f'cast) -0.2% Y-O-Y -0.2% Median -0.2% Range -0.3%:+0.2%
Tue 29	<b>GDP (final)</b> Q2 (2nd estimate) -0.7% Y-O-Y -5.5% Q2 (f'cast) -0.6% Y-O-Y -5.4% Median -0.6% Range -0.7%:-0.5% <b>Current account</b> Q1 -£8.5bn Q2 (f'cast) -£7.8bn Median -£7.8bn Range -£8.0bn:-£6.1bn <b>Money supply, M4 (final, sa)</b> Jul +1.3% Y-O-Y +14.4% Aug (prel) +0.1% Y-O-Y +12.6% <b>Consumer credit</b> Jul -£0.2bn Aug (f'cast) zero Median +£0.1bn Range -£0.2bn:+£0.3bn <b>Net mortgage lending (sa)(Aug)</b> Jul -£0.4bn Aug (f'cast) +£0.3bn Median +£0.2bn Range +£0.2bn:+£0.3bn <b>Mortgage approvals</b> Jul 50.1K Aug (f'cast) 51.5K Median 51.0K Range 50.0k:54.0k <b>CBI distributive trades' survey (11:00)</b> Sep (f'cast) -13	<b>House prices (S&amp;P/CaseShiller)(Jul)(14:00)</b> Jun Y-O-Y -15.44% <b>Consumer confidence (15:00)</b> Aug 54.1 Sep (f'cast) 58.0 Median 57.0 Range 54.5:62.1	<b>EU-16 consumer confidence (10:00)</b> Aug -22 Sep (f'cast) -22 Median -21 Range -22:-19 <b>EU-16 industrial confidence (10:00)</b> Aug -26 Sep (f'cast) -25 Median -24 Range -26:-22
Wed 30	<b>Consumer confidence (GfK) (00:01)</b> Aug -25 Sep (f'cast) -23 Median -24 Range -25:-22	<b>ADP employment change (13:15)</b> Aug -298K Sep (f'cast) -200K Median -190K Range -260K:-133K <b>GDP (sa, annualised) (13:30)</b> Q2 (2nd estimate) -1.0% Q2 (f'cast) -1.0% Median -1.2% Range -1.4%:+3.0% <b>GDP deflator (sa, annual) (13:30)</b> Q1 zero Q2 (f'cast) zero Median zero Range zero:+0.1% <b>Chicago PMI (14:45)</b> Aug 50.0 Sep (f'cast) 51.0 Median 52.0 Range 50.4:54.6	<b>French producer prices (07:45)</b> Jun +0.6% Y-O-Y -8.7% Aug (f'cast) +0.6% Y-O-Y -8.6% Median +0.2% Range -0.5%:+0.6% <b>German unemployment (sa) (08:55)</b> Aug -1K Rate 8.3% Sep (f'cast) +25K Rate 8.4% Median +20K Range -20K:+45K <b>EU-16 CPI (10:00) (flash)</b> Aug Y-O-Y -0.2% Sep (f'cast) Y-O-Y -0.2% Median -0.2% Range -0.3%:+0.1%
Thu 1 Oct	<b>Halifax house prices (sa) (Sep) (1-9)</b> Aug +0.8% 3m/Y-O-Y -10.1% <b>Manufacturing PMI</b> Aug 49.7 Sep (f'cast) 50.1 Median 50.1 Range 49.4:52.0	<b>Personal income (13:30)</b> Jul zero Y-O-Y Aug (f'cast) +0.1% Y-O-Y Median +0.1% Range -0.1%:+0.4% <b>Personal spending (13:30)</b> Jul +0.2% Y-O-Y Aug (f'cast) +1.0% Y-O-Y Median +1.1% Range +0.1%:+1.6% <b>Core PCE deflator (13:30)</b> Jul +0.1% Y-O-Y +1.4% Aug (f'cast) +0.1% Y-O-Y Median +0.1% Range zero:+0.1% <b>Initial claims (w/e 26/9) (13:30)</b> Previous 530K Forecast 525K <b>ISM manufacturing index (15:00)</b> Aug 52.9 Sep (f'cast) 54.0 Median 54.0 Range 52.0:56.0	<b>German retail sales (07:00)</b> Jul +0.7% Y-O-Y -1.0% Aug (f'cast) -0.3% Y-O-Y -1.5% Median +0.2% Range -0.8%:+0.5% <b>French manufacturing PMI (08:50) (final)</b> Sep (prel) 52.5 Sep (f'cast) 52.5 <b>German manufacturing PMI (08:55)(final)</b> Sep (prel) 49.6 Sep (f'cast) 49.6 Median 49.6 Range 49.5:49.8 <b>EU-16 manufacturing PMI (09:00) (final)</b> Sep (prel) 49.0 Sep (f'cast) 49.0 Median 49.0 Range 48.2:49.7 <b>EU-16 unemployment rate (10:00)</b> Jul +9.5% Aug (f'cast) +9.6% Median +9.6% Range +9.6%:+9.7%
Fri 2	<b>Nationwide house prices (07:00) (Sep)</b> Aug +1.6% Y-O-Y -2.7%	<b>Non-farm payrolls (13:30)</b> Aug -216K Sep (f'cast) -200K Median -187K Range -250K:-100K <b>Unemployment rate (13:30)</b> Aug 9.7% Sep (f'cast) 9.8% Median 9.8% Range 9.6%:9.9% <b>Average earnings (sa) (13:30)</b> Aug +0.3% Y-O-Y +2.6% Sep (f'cast) +0.2% Y-O-Y Median +0.2% Range zero:+0.3% <b>Average weekly hours (sa) (13:30) (Jun)</b> Aug 33.1 Median 33.1 Range 33.1:33.2 <b>Factory orders (15:00)</b> Jul +1.3% Aug (f'cast) +1.0% Median +1.0% Range -1.0%:+3.8%	<b>EU-16 producer prices (10:00)</b> Jul -0.8% Y-O-Y -8.5% Aug (f'cast) +0.5% Y-O-Y -7.3% Median +0.4% Range zero:+0.6%
Mon 5		<b>ISM Services index (15:00) (Sep)</b> Aug 48.4	<b>French services PMI (08:50) (final)(Sep)</b> Sep (prel) 52.5 <b>German services PMI (09:00) (final)(Sep)</b> Sep (prel) 52.2 <b>EU-16 services PMI (09:00) (final)(Sep)</b> Sep (prel) 50.6 <b>EU-16 retail sales (10:00)</b> Aug -0.2% Y-O-Y -1.8%

NB: UK data released at 9.30 a.m., unless otherwise stated. Market medians are as of preceding Friday. Release times of US data are stated in brackets after the description of the indicator. Events are listed in the events column on the next page.

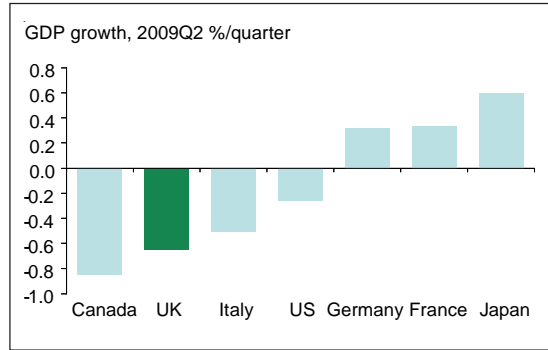
# 28 September - 5 October 2009

Date	Japan	Other Countries	Main events
Mon 28			<ul style="list-style-type: none"> <li>• ECB President Trichet speaks before EU Parliament's Economic Committee (15:30)</li> </ul>
Tue 29	<b>Tokyo core consumer prices (00:30)</b> Aug Y-O-Y -1.9% Sep (f'cast) Y-O-Y -2.0% Median -2.0% Range -2.2%:-1.4% <b>National core consumer prices (00:30)</b> Jul Y-O-Y -2.2% Aug (f'cast) Y-O-Y -2.5% Median -2.4% Range -2.6%:-1.1%		<ul style="list-style-type: none"> <li>• ECB conducts long-term repo operation</li> <li>• Fed member Fisher speaks in Dallas (14:50)</li> <li>• UK DMO to sell £3.75bn 4% gilts due 2022 (10:30)</li> <li>• Fed to purchase Notes/Bonds (16:00)</li> </ul>
Wed 30	<b>Industrial output (00:50) (prel)</b> Jul Y-O-Y -22.7% Aug (act) Y-O-Y -18.6% Median -18.8% Range -19.4%:-18.0%	<b>Canada IPPI (13:30)</b> Jul -0.5% Aug (f'cast) +0.5 Median +0.5 Range -0.2%:+0.7% <b>Canada RMPI (13:30)</b> Jul -3.8% Aug (f'cast) +3.5% Median +3.0% Range +0.8%:+5.0% <b>Canada GDP, monthly (13:30)</b> Jun +0.1% Jul (f'cast) +0.4% Median +0.4% Range zero:+0.7%	<ul style="list-style-type: none"> <li>• Fed member Plosser speaks</li> <li>• ECB member Papademos speaks in Sweden (08:45)</li> <li>• ECB member Weber speaks in Sweden (08:45)</li> <li>• ECB member Noyer speaks in Sweden (08:45)</li> <li>• Fed member Lockhart speaks in Alabama (15:30)</li> <li>• Fed member Kohn speaks on "Exit Policies" (17:35)</li> <li>• ECB President Trichet speaks at Eurofi Financial Forum in Sweden (18:45)</li> </ul>
Thu 1 Oct	<b>Tankan manufacturing index (00:50)</b> Q2 -48 Q3 (f'cast) -34 Median -33 Range -40:-25 <b>Tankan services index (00:50)</b> Q2 -29 Q3 (f'cast) -28 Median -26 Range -50:-19 <b>Retail sales (00:50)</b> Jul +0.5% Y-O-Y -2.4% Aug (f'cast) +0.4% Y-O-Y Median +0.3% Range -0.6%:+0.8%		<ul style="list-style-type: none"> <li>• BoE publishes Quarterly Credit Conditions Survey (09:30)</li> <li>• Fed Chairman Bernanke testifies before House Financial Services Committee (14:00)</li> <li>• UK DMO to sell £2.25bn 4.75% gilts due 2030 (10:30)</li> </ul>
Fri 2	<b>Job-applications ratio (00:30)</b> Jul 0.42% Aug (f'cast) 0.42% Median 0.42% Range 0.41%:0.44% <b>Unemployment rate (00:30)</b> Jul 5.7% Aug (f'cast) 5.8% Median 5.8% Range +5.7%:+5.8% <b>Workers' spending (00:30)</b> Jul Y-O-Y -2.0% Aug (f'cast) Y-O-Y -0.1% Median -0.2% Range -1.75%:+1.0% <b>Monetary base (00:50)</b> Aug Y-O-Y 6.1% Sep (f'cast) Y-O-Y +5.9%		
Mon 5			

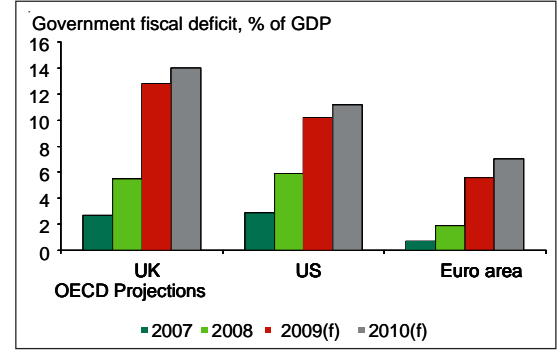
**2009/10 calendar of central bank meetings**

**European ECB (1.00%)**  
 8 October, 5 November, 3 December  
**US FOMC (0-0.25%)**  
 4 November, 16 December, 27 January, 16 March  
**UK MPC (0.50%)**  
 8 October, 5 November, 10 December, 7 January

**Chart b: UK economy lags the global recovery**



**Chart c: UK public sector borrowing has risen sharply and is set to increase further**



**Rolling calendar of UK data releases and events**

Q2 GDP (29/9)  
 Mortgage approvals (29/9)  
 M4 money supply (29/9)  
 CBI distributive trades (29/9)  
 GfK consumer conf (30/9)  
 Manufacturing PMI (1/10)  
 Services PMI (2/10)

Looking ahead, there are a number of reasons to believe that sterling may continue to weaken. Firstly, the UK has lagged, and is likely to continue to lag, the global economic recovery – see chart b. This underperformance may partly be structural, related to the high level of UK private sector indebtedness, and the relatively larger role financial services have traditionally played in the UK. As a result, a weaker currency may be required to boost growth. Second, it is likely that UK interest rates may remain lower for longer than those in many other countries, thus weakening the relative returns on sterling assets. Third, public sector net borrowing in the UK has risen far more sharply than in other countries over recent years – see chart c - implying a real exchange rate depreciation.

All these factors appear to help explain the recent fall in sterling. More fundamentally, as the Bank of England suggests in its latest Bulletin, they may have been responsible for a reduction in sterling's long-run sustainable value. Given that sterling's real exchange rate is not particularly undervalued, the correction in sterling is likely to have further to go, albeit erratically, before finding a new equilibrium.

**Fall in sterling essential for a successful rebalancing of the UK economy**

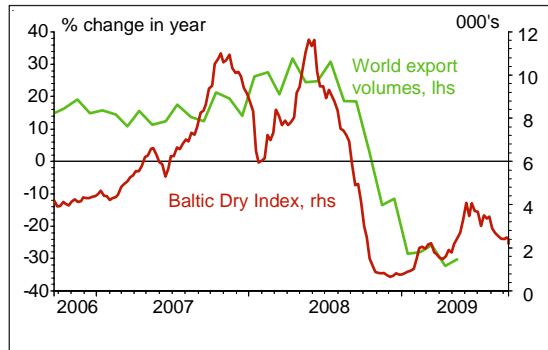
Indeed, the adjustment is part of a necessary rebalancing of the UK away from domestic demand towards net trade. But for the UK economy to successfully rebalance over the coming years, not only will the exchange rate need to fall further, but domestic demand in other countries will also need to recover. China is a case in point. Policies currently being pursued there are aimed at stimulating domestic demand and reducing their country's reliance on net exports.

**Rolling calendar of US data releases and events**

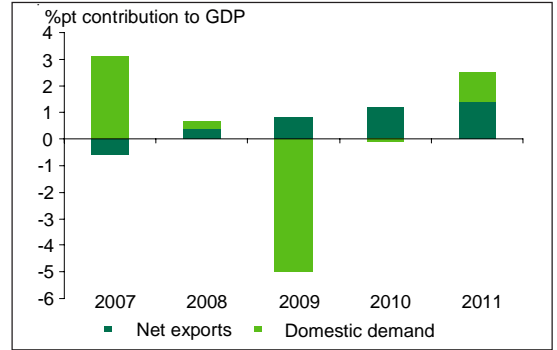
Consumer conf (29/9)  
 Q2 GDP (30/9)  
 Chicago PMI (30/9)  
 Core PCE deflator (1/10)  
 ISM manufacturing (1/10)  
 Non-farm payrolls (2/10)  
 Unemployment rate (2/10)

The UK economy has much to gain from an opening of China's markets and a recovery in export markets elsewhere. Judging by the improvement in some global leading indicators, such as the Baltic Dry Index, global trade volumes are beginning to rise again, see chart d. If the UK economy can face into the improvement in global growth with a competitive exchange rate, the prospects of a successful rebalancing of the UK economy would be substantially enhanced. We believe it can do, with a further fall in sterling a pre-requisite. As chart e shows, we expect net exports to contribute more to UK gdp growth over the coming years.

**Chart d: Rise in Baltic Dry Index leads the improvement in global trade**



**Chart e: UK rebalancing away from domestic demand set to continue**



Adam Chester, Senior UK Economist, Corporate Markets

**\* All charts are sourced to Lloyds TSB Corporate Markets Economic Research, Bloomberg, IMF and Datastream**

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