What will the Sterling Dollar Exchange Rate be in Five Years' Time?[1]

Dr. Stephan Pfeffenzeller examines the five year outlook for sterling against the dollar.

The British pound has been increasing in value relative to the US dollar from 2001 and currently has a value of around $2 to the pound. This article will explore expectations for the future movement of the exchange rate based on the current economic situations of the US and the UK and the policy orientation of their respective monetary authorities.

Both the US and the UK have experienced a period of low inflation and low interest rates for the past decade or so with real interest rates consistently below 5% from 2002 onwards. While these conditions produced mostly robust GDP growth and a sustained rise in housing prices, they also led to the present credit crisis. This background scenario is important in that it defines the conditions which will determine future exchange rate developments.

Basic Aspects of Exchange Rate Determination

The exchange rate is defined as the price of one currency in terms of another. The value of this price and changes in the price level depend on demand and supply for the currencies in question. As demand for a given currency increases so does its value; as demand for the currency falls, it depreciates.

Demand for a currency arises mainly from a desire to invest in the country that issues it or from demand for goods produced by this country. Thus, if investment in an economy becomes more profitable, there should be an increase in investment and therefore an increase in demand for its currency. If a country's exports become more competitive, trade-related currency demand should increase.

Exchange Rates in the Short Run

What differs is the time over which both factors take effect. Changes in the rate of interest tend to affect investment yields quickly, and interest rates themselves can change at short notice. Interest rate changes are therefore likely to drive exchange rate movements in the short term.

There are other drivers of short-term currency demand which are harder to predict. Widespread expectations of an imminent depreciation, for example, may in themselves make investors more reluctant to hold assets in the affected currency. This will tend to weaken the currency in question unless investment yields are high enough to compensate for the depreciation risk.

If an economy's interest rate rises while other risk factors remain the same, investment-led demand for the currency in question should increase. On the other hand, investment inflows will increase the amount of money available in the economy and therefore tend to drive interest rates down. In this way, investment will lead to arbitrage, with investment flows continuing until interest rates in different economies are at similar levels, allowing for differences in risk and expectations.

Exchange Rate Determinants in the Long Run

If prices for domestically produced goods fall relative to those of foreign output, then exports become more competitive. As net exports increase, more domestic currency is demanded and the exchange rate would tend to appreciate. This is why relatively lower inflation compared to other countries tends to strengthen the domestic currency while relatively higher inflation favours a depreciation.

Trade flows adjust more gradually than short-term investment flows. The effect of different inflation rates on the exchange rate should therefore be crucial for long-term expectations. An assessment of the US$/£ exchange rate will accordingly be based on an assessment of relative inflation performance.

What to Expect

Over the first years of the twenty-first century, both the UK and the US have experienced similar rates of relatively low inflation. In spite of the fact that US interest rates have been somewhat higher than those of the UK for most of this time, the pound has almost consistently appreciated against the US$.

In the wake of the current credit crisis, the Bank of England's more anti-inflationary stance has tended to support the currency at a high value. UK interest rates have so far remained above US levels (with three-month interest rates of 5.89% and 2.07% for the UK and US respectively). Inflation rates, while rising, have been contained below those of the US: the annual inflation figure for the UK was 2.5% in March, while the corresponding figure for the US was 4%.

The Federal Reserve Bank, by contrast, has placed more emphasis on containing the threat of recession during the current

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[1] *Historical background data on inflation, real interest rates, nominal lending rates and the official exchange rate for the period 1961–2006 can be obtained from the Worldbank World Development Indicators. Recent data on inflation, exchange rates and the budget deficit are available from The Economist, and public debt data for 2007 were obtained from the CIA World Factbook rankings.*

crisis. It is therefore likely that the pound will retain its strong position in relation to the US$ in the short term.

The Long-term Prospect

It has been pointed out that, in the long run, the exchange rate is driven by inflation differentials. In contemplating how the US$/£ exchange rate will develop over the next five years, one will therefore have to ask how inflationary pressures are likely to develop in both economies over this time horizon.

The difference in policy orientation among the central banks would seem to favour a sustained strong performance of the pound. There are some factors complicating this assessment though. Inflation performance over the coming years is likely to be at least partially dependent on current inflation. Expectations of the Bank of England's ability to control the inflation rate over the relevant time horizon should therefore be formed taking its present success into account.

By this standard, inflation may well be higher than desired. UK inflation has repeatedly been surpassing its target rate in spite of the notionally higher inflation aversion. In addition, the inflation measure adopted – the CPI – excludes housing costs and therefore arguably underestimates inflation.

Another way of looking at the long term is by asking what motivates the monetary authorities to keep inflation down. High government debt is frequently seen as a motive for tolerating high inflation: as inflation takes effect, the real value of the debt tends to fall. The UK's public debt amounted to 43% of GDP in 2007, compared to a US figure of 36.8%; the corresponding data for the budget deficit are 3.2% and 2.4% for the UK and the US respectively. With the UK's public debt burden exceeding that of the US, Britain's pro-inflation bias, and hence the prospect of a weakening currency, would at first sight seem stronger.

How this plays out in practice will largely depend on how well the institutional design of the UK's monetary system works. The Bank of England is independent in its use of monetary policy but is bound to a government-set inflation target. If the system works as planned, it should only be possible to let the rate of inflation rise intentionally if a higher inflation target is announced explicitly.

There is a possibility, though, that the system may not work as intended and that informal pressure may be brought on the central bank. Alternatively, the Bank of England may simply be swayed in its resolve by other economic issues. A strong appreciation in relation to the US$ would reduce British exports and could deepen an ongoing recession. In theory, the central bank is supposed to concentrate on containing inflation. In practice, it may quite sensibly refuse to ignore other factors if the associated problems get too big.

Expectations of the future course of UK monetary policy would therefore need to ask what cost Britain is willing to incur in fighting inflation and how far the UK is willing to deviate from the policy stance of the Federal Reserve Bank.

Exchange Rate Expectations

In view of the economic uncertainties, predictions of future developments of the US$/£ exchange rate will have to be scenario based. Econometric forecasting methods would work best if the development of the exchange rate depended on predictable regularities. In the present case we are faced with prospective discrete changes in policy conditions so it seems appropriate to consider in which direction the exchange rate would move under what circumstances.

One possibility would be based on a simple extrapolation of current differences in policy orientation. With similar macroeconomic conditions in terms of public debt and similar problems in the housing market, the strength of anti-inflationary policy commitment easily stands out as the determining factor. The Bank of England has so far shown a stronger focus on inflation containment and is institutionally committed to inflation targeting.

Furthermore, the current crisis is the first major test of the Bank's resolve in pursuing its mission, so its future reputation will largely depend on its current performance. The Bank of England's policy bias should therefore translate into a policy orientation favouring a strong pound against the dollar.

Another view would emphasise that policy objectives are liable to differ from policy achievements. The Bank of England's recent performance in actually containing inflation within the target range is not impressive. Its resolve to continue with a high interest rate policy during a prolonged recession and in the face of weak exports is also open to question. Given the existing macroeconomic similarities with the US, it would then be likely that the pound adjusts at least partly to changes in the US$ as against third currencies.

In conclusion, it appears likely that the pound could depreciate somewhat from its current strong position, possibly to a value of around US$1.8 to the pound, over the coming five years. There is a possibility, however, that the current strength of the pound could be sustained if the Bank of England proves highly successful in controlling inflation.

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