

Sterling

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With the summer holidays fast approaching, thoughts turn to how many Euro, Dollars, etc one can get for a Pound. Over recent months the Pound has had a fairly rocky ride, falling to an all time low against the Euro and its lowest level for almost a quarter of a century against the Dollar. The strength, or weakness, of a currency can be regarded as a barometer of the health of a country's economy. So what are the factors that affect the exchange rate?

Inflation

If inflation in the UK is lower than elsewhere, then UK exports will become more competitive leading to an increase in demand for UK produced goods and services, this in turn will increase the amount of Sterling bought. Foreign goods will become more expensive so the supply of Sterling will reduce, pushing up the exchange rate.

Interest Rates

If UK interest rates rise relative to elsewhere it will become more attractive to deposit money in the UK, therefore, demand for Sterling will rise increasing the exchange rate. There is a large inter-relationship between inflation and interest rates in that the bigger the gap between inflation and interest rates the more attractive a currency becomes, increasing its exchange rate.

Speculation

There is a very active market in currency trading. Investor sentiment can be sufficient to alter exchange rates one way or another, sometimes ignoring the fundamental strengths of the underlying economic indicators. It was speculation by the (in)famous George Soros that led to the UK's withdrawal from the European Exchange Rate Mechanism (ERM) in 1992. He borrowed billions of Dollars to bet against the Bank of England's ability to maintain Sterling's position in the ERM. He won and reputedly personally profited to the tune of around \$1 billion.

Relative strength of other currencies

This is perhaps one of the main factors behind the recent strengthening

of Sterling. Even though there has been the threat that the UK might lose its AAA credit rating (the best you can get) the Pound has continued to appreciate against both the Euro and Dollar. This is largely not due to the strength of the UK's economy but to the fact that hopes are growing that the worst of the recession may be over. In times of uneconomic uncertainty investors look for safe havens such as the Dollar and, to a lesser extent, the Euro. As 'normality' returns so does the appetite for risk which benefits the Pound.

Exchange rates and the various factors that influence them is a very complex area. The Economist magazine has a novel way to try and simplify it. The argument is that in a free market a currency should find its natural position relative to all other currencies, so that the cost of an item in one country should be the same in another once the exchange rate has been taken into account. The Economist introduced the Big Mac Index charting the cost of a McDonalds Big Mac as it is produced in over 120 countries. Using their February 2009 Big Mac Index as a guide the best value destination is Malaysia with Norway being the most expensive.

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