# British pound falls to new lows on currency markets

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The Bank of England cut its interest rate to 2 percent on Thursday, bringing the UK base rate to its lowest level since 1951. This historically low level reflects the scale of the crisis that has hit the British economy after decades of being the favoured destination for global flows of speculative money.

In the run-up to the interest rate cut, the pound fell to US$1.45. This is its lowest level against the dollar for six years. As recently as July the pound was trading at US$2.00. From its peak, the pound has fallen by a total of 30 percent against the dollar.

The pound hit its lowest ever level against the euro at €1.1 and a 10-year low against the Japanese yen. It has lost 45 percent of its value against the yen since last summer. The extent of the fall in the pound is comparable to its collapse in 1992, when it was forced out of the European Exchange Rate Mechanism.

Market analysts expect the pound to come under further pressure in expectation of more rate cuts over the next weeks. Markets are anticipating that the benchmark UK interest rate will hit zero early next year.

Many economists have argued that the best policy would be to go straight to that level. Professor Willem Buiter, a former member of the Bank of England Monetary Policy Committee, has argued that all the major economies should cut interest rates to zero.

"If zero is the floor, there is no reason not to go there immediately," Buiter wrote in the *Financial Times*. "The recession in the US, the UK, the Eurozone, Japan and the rest of Europe is, with probability verging on certainty, going to be so deep and so prolonged that the zero lower bound will be reached even by the most anal-retentive gradualist central bank before the middle of 2009. So why not get it over with in December 2008 and possibly do some good in the mean time?"

Other commentators see zero percent as an immediate necessity for the UK and regard the latest rate cut, unprecedented though it is, as insufficient. "There's no point in saving bullets when there's nothing left to shoot," said Neil Jones of Mizuho Capital Markets after the Bank of England cut its rate. "The impact on sterling will be negative."

**Deepening recession**

The reason for the drastic fall in the pound is the state of the British economy. "The outlook for the British economy is particularly dire," the *Economist* warned, "because it has been hit so hard by the banking crisis." As a result, "Lending to the sectors that matter—households and non-financial companies—has essentially stalled since the summer."

Lending has dried up because banks are attempting to shrink their balance sheets so that they can stay in profit. But the effect of every bank doing this is to send the whole economy into a further downward spiral. The banks are shifting the risk from their own balance sheets to other companies and to working people who lose their jobs and homes.

Recent economic data has pointed to Britain entering a deeper recession, and at a more rapid rate, than was expected. Recent surveys of manufacturing, services and construction show that British gross domestic product (GDP) is falling by 0.8 to 0.9 percent in the fourth quarter, as compared to 0.5 percent in the third quarter.

House price inflation was one of the results of the flood of money into the UK. Britain came top of the house price inflation league of industrialised countries earlier this year. The fall has been correspondingly dramatic. Prices have fallen by 18 percent since their peak last year. The average house price fell by £144 a day in November.

The fall in house prices has not made it easier to buy a home. According to Bank of England figures, just 32,000 new mortgages were approved during November. The monthly average in 2007 was 104,000.

The government's hastily unveiled plan to reduce the number of home repossessions was dismissed by leading UK house builder Bellway. Finance director Alistair Leitch said it would have "absolutely zero effect on new housing. It will not entice Joe Public to buy a new property." Leitch identified concerns about unemployment as the major factor in slumping house sales. "If you feel any insecurity in your job you are not going to go out and buy a house."

His impression was confirmed by a new survey of job trends, which showed that the UK job market is weakening rapidly.

"The UK jobs market is heading downhill at breakneck speed," said Mike Stevens at KPMG. "Employers in almost all sectors have drastically cut recruitment plans and are shedding contract and temporary staff as fast as they can."

The contraction of the job market is reflected in record falls in pay levels for both permanent and temporary staff.

In the latest round of job losses in the finance sector, Nomura has cut 1,000 jobs in London after it acquired the European branch of Lehman Brothers. Up to 800 jobs are under threat after Honda decided to withdraw from Formula One racing. The job losses cover all sectors of the economy. Some 3,000 jobs are threatened in the tax service.

The same pressures on jobs and credit are reflected in new car sales, which fell by 37 percent last month, according to the Society of Motor Manufacturers and Traders. At the top end of the market, Aston Martin's sales fell by 73 percent. But the high volume brands were also hit by falling sales.

"The scale of the downturn in the UK manufacturing PMI [Purchasing Managers Index] data during November is unprecedented," said Rob Dobson, an economist who has just carried out a survey of manufacturing industry in Britain. The decline in manufacturing has reached "absolutely horrific levels," he said.

"We are already seeing a pretty rapid pace of contraction in hard manufacturing activity in the UK," said Alan Clarke at BNP Paribas, "and it is going to get even worse."

**Europe**

The cut in British interest rates was part of a general move by the world's central banks in response to the deepening recession. The European Central Bank (ECB) cut its rates by three quarters of a percentage point. By the standards of the ECB, this is a huge cut. Over recent months, it has never cut by more than one half of a percent. Interest rates in the Eurozone now stand at 2.5 percent.

Sweden cut its rates by a massive 1.75 percent, bringing the base rate down from 3.75 percent to 2.00 percent. Sweden's action was in response to worsening economic data. Growth of 0.1 percent had been anticipated, but the latest figures point to a contraction of 0.5 per cent in Sweden's export-oriented economy.

Even in this context of sharply deteriorating economic conditions across Europe, the situation facing the British economy looks more serious than elsewhere because of its dependence on finance capital and cheap credit.

The fall of the pound has led to speculation that Britain may have to join the euro. European Commission president José Manuel Barroso recently said that he thought British membership was "closer than ever before."

"Some British politicians have already told me: 'If we had the euro, we would have been better off,' " Barroso told French radio.

Foreign Secretary David Miliband and Lord Mandelson, the business secretary, are thought to be the most likely government figures behind these rumours. But even the Conservative shadow chancellor, George Osborne, has adopted some of the arguments being advanced by economist Buiter, a strong advocate of the euro.

Osborne warned that the government's fiscal stimulus package and the huge increase in government borrowing that it entails could cause a run on the pound. His concerns were ridiculed by Anatole Kaletsky in the *Times* of London, who argued that "…in the modern world of paper money and floating exchange rates, there is no such thing as a 'reserve currency'—only different currencies that are traded and used as stores of value in the same way as other assets."

Kaletsky agreed with Sir Samuel Brittan of the *Financial Times,* who recently wrote: "The most frequent objection is to ask: 'Where will the money come from?' The short answer is: the Bank of England printing works in Debden. This is not just a debating reply. In a paper currency system there is no fixed pot of money, but a total influenced by human action."

While this could, Kaletsky admitted, lead to Zimbabwe-style inflation, under present deflationary conditions such an outcome was not inevitable.

Kaletsky's articles are in their way quite chilling. They demonstrate that policy options that would until quite recently have been denounced as actions reserved for megalomaniac dictators have entered into the realm of, if not the desirable, then at least the possible, for sections of the British political elite.

A falling pound poses a serious danger for millions of ordinary British people since almost every daily essential, from food to fuel and manufactures, is imported. The dominance of finance capital has left the UK with a manufacturing sector that accounts for no more than 16 percent of GDP, while the service sector, much of it related to finance, accounts for 73 percent.

Joining the euro does not offer a lifeline, since it would not offer a solution to the economic and fiscal problems that underlie the falling pound. With government borrowing now set to rise to 57 percent of GDP, it might not even be possible.

Britain's borrowing requirement puts it well outside the convergence criteria originally set for euro membership. The criteria might be relaxed because so many existing member countries are now outside those criteria, too. They have also had to borrow vast amounts in response to the credit crunch. Ultimately, the decision is a political one, and as national tensions increase in Europe, the other members may be unwilling to admit Britain.

Even as a member of the euro, Britain would still have to raise money by selling bonds on the international markets to finance its fiscal policies. The cost of doing so depends on the perceived risk that a government will default on the bonds it issues.

The markets use credit default swaps (CDS's) to insure against government bond defaults. The price of CDS's has risen for all the major economies. Simply being in the euro does not protect a government against the risk of default. Italy, a euro member, has the highest CDS price because its debt-to-GDP ratio is now the highest in the Eurozone, at 103 percent.

But the price for British CDS's has risen the fastest. The price of insuring £10m of UK debt against default over five years has risen from £8,000 last February to £60,000 in the middle of November, and has now reached £110,000 (US$162,000).

According to the *Financial Times*, "It now costs more to ensure the UK against default than some of its banks such as HSBC and Lloyds."

"No one expects the UK to actually default," said Roger Brown, global head of rates research at UBS, "but the risk is higher because of the amount of debt."

No one may expect a country like the UK to default, but until recently no one expected a major bank to go under either, still less a whole string of banks. Amid so many unknowns, one thing is certain. The experts may disagree on the correct response, but they are all agreed on who should bear the cost of the recession that is engulfing the world economy—the working class.

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