



DOES A \$2 POUND HERALD ECONOMIC RECESSION FOR THE UK?

- **\$2 level has more psychological than economic importance, says Fidelity International**

Sterling last nudged \$2 in the late summer of 1992* as the beleaguered Conservative Government of the day imposed successive interest rate rises in a futile attempt to keep the UK in the European Exchange Rate Mechanism (ERM). When the UK crashed out of the ERM, the pound fell back against the dollar.

Difficult economic conditions also accompanied sterling's previous break through the \$2 level in June 1981. Recession in the UK was linked to global stagflation – rising prices and slowing economic growth – in the wake of the 1979 oil shock. Policymakers used high interest rates to tackle inflation as unionised workforces campaigned for higher wages.

On the surface, there are some parallels with the current situation, says Michael Gordon, chief investment officer of Fidelity International. “UK inflation rose to 3.1% in March this year and although it has fallen back to around 2.5% it is still above the Government's 2% target – and it is clearly a concern for the Bank of England. An interest rate rise of 0.25% to 5.75% this week is possible and UK base rates are, in a global context, already high.

“But there appears very little chance of recession in the UK this year or next. Inflation is much lower than in the 1970s or late 1980s when it was out of control. The price of oil, a significant driver of inflation, has fallen since last summer. Crude has fallen from \$79 a barrel in August 2006 to around \$71 today, and lower fuel costs have started to filter through to consumers**.

“In addition, China is expected to remain a deflationary force in the global economy for some time yet, having amassed excess capacity in a range of industries from steel to



automobiles. And the direct impact of a strong currency on the UK economy is unlikely to have as much force as in previous decades because manufacturing's share of GDP has shrunk. Today it accounts for only 14% of GDP, compared with around 40% 50 years ago.**

More psychological than economic importance

But does the \$2 level have the significance it once did? When you look at real – adjusted for inflation - rather than nominal currency exchange rates, then a different picture emerges. As revealed by the table below for Purchasing Power Parity, sterling doesn't buy as many "real" bucks as it once did.

Throughout the 1970s and 1980s, inflation was rising at a much faster pace in the UK than in the US. This has eroded the purchasing power of sterling for dollar-priced goods, says Michael Gordon.

"If the exchange rates since June 1981 are adjusted to take account of the relative differences in the two countries' rate of inflation, then sterling really is worth only 1.60 dollars in terms of purchasing power. Twenty six years ago, your pound would have bought you \$2 of goods; today your pound would buy only \$1.60 of those same goods, adjusted for inflation."

Dollar/sterling purchasing power parity***

	PPP exchange rate	Overvaluation of \$2
1980	2.09	-4%
1981	2.05	-2%
1982	2.02	-1%
1983	1.99	0%
1984	1.98	1%
1985	1.93	4%
1986	1.91	5%
1987	1.86	7%
1988	1.81	10%
1989	1.75	14%
1990	1.69	19%
1991	1.64	22%
1992	1.61	24%



1993	1.61	25%
1994	1.61	24%
1995	1.60	25%
1996	1.59	26%
1997	1.60	25%
1998	1.58	26%
1999	1.55	29%
2000	1.58	27%
2001	1.61	25%
2002	1.64	22%
2003	1.60	25%
2004	1.62	24%
2005	1.62	24%

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Notes to editors:

*Source: DataStream as at 24/01/07

**Source: FT as at 02.07.07

***Source: OECD PPPs for GDP – Historical Series 1980-2005

****Source: Fidelity as at 31.03.07

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