Pound overvalued by 25%, say forecasters

By Robert Chote, Economics Editor

The pound is 25 per cent above its long-term sustainable level, implying that typical estimates of the exchange rate at which the UK could safely join Europe’s single currency are dangerously overambitious.

The conclusion emerges from an authoritative study produced for the Institute of International Economics in Washington.

The authors correctly predicted, before Britain joined the European exchange rate mechanism in 1990, that a DM2.95 central rate would be unsustainable.

The latest study, by Simon Wren-Lewis and Rebecca Driver of Exeter University, suggests that sterling’s "equilibrium" exchange rate against the D-Mark lies between DM2.10 and DM2.50. Not only is this well below the current rate of DM2.91, but it also lies below the DM2.60 that many observers see as a plausible entry rate for Ecu.

The study uses the "fundamental equilibrium exchange rate" methodology developed by John Williamson and widely used to examine medium-term currency movements.

The approach begins by assessing the trend flows of international capital into and out of the country. This depends on private sector saving and investment, as well as the medium-term path of fiscal policy.

Structural inflows and out-
flows of capital in the UK are roughly equal, which means that the UK can sustain a current account deficit of 0.2 per cent of gross domestic product. By comparison, the US can sustain a 2 per cent deficit and Japan needs a 1.9 per cent surplus.

The equilibrium real exchange rate is the one that delivers this current account position when the economy is running at a trend rate of capacity consistent with stable inflation.

Sterling's strength is already pushing the UK's current account into the red and the report suggests that the deficit will quickly widen to unsustainable levels if sterling remains at its currently highly overvalued rate.

Prof Wren-Lewis said that sterling's recent strength had led commentators to raise their estimates of sterling's long-term sustainable exchange rate, but with little justification. But he added that it was quite possible for sterling to fall to sustainable levels by the time the government was considering Ecu entry early in the next parliament.

The study also suggests that the French franc, Italian lira and D-Mark are all near their sustainable exchange rates with each other at the moment, which implies that Ecu entry should be relatively comfortable for them. But the dollar is 30 per cent overvalued against the yen and 5-15 per cent overvalued against the D-Mark.