The Economist

Buttonwood's notebook
Financial markets

Sterling's strength
In the land of the blind...

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IT DOESN'T take much, it seems, to generate some momentum in a currency these days. The pound is at its highest (http://in.reuters.com/article/2014/02/17/markets-sterling-open-idINL6N0LM15720140217) , on a trade-weighted basis, since late 2008 and seems to be closing in on $1.70 against the dollar. An influx of money from Vodafone's sale of its stake in Verizon Wireless may be one short-term factor driving sterling higher, but so is speculation about the likely policy stance of the Bank of England. Brokers' notes with titles such as "forward misguidance" or "forward guidance RIP" give the impression of a major change in the interest rate outlook; the first rate rise is pencilled in for early next year, it seems. (And if you look at short sterling (https://globalderivatives.nyx.com/contract/content/29101/settlement-prices) futures, a rate rise is pencilled in by Decemnber; there is a more than 25bp gap between the March and December prices.)

But are the brokers right? A cynic might suggest that the Bank was trying to wiggle its way out of an awkward situation last week; it had relied on an unemployment measure as a target, but looked like hitting the target two years' early. As a result, it made its advice less specific (why make the same mistake twice?). Yes, the Bank increased its forecast for GDP growth. But why does anyone believe the Bank's forecasts? It consistently predicted that inflation would fall back to 2% within a two year horizon, but tthis measure was above target for four years. And it has just got its unemployment forecast completely wrong.

Meanwhile, there are old-fashioned reasons for the currency markets to worry about the pound. Start with the trade deficit. December's figures showed an improvement but the previous trend was dire; in the third quarter of 2013, the deficit was 5.1% of GDP. Currency rallies don't usually occur in the face of such deficits. And then there is political risk - over the next three years we have a European parliamentary election that UKIP might win, the Scottish referendum on leaving the UK, and a general election that might lead either to a Labour victory (with a seemingly anti-business agenda) or a Conservative victory that might lead to the UK's exit from the EU.

So the lesson is that, in a world where monetary policy is committed to near-zero rates, any country that even hints at tightening will see its currency shoot up, no matter how weak its fundamentals.