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In The New World Order, Sterling Should Suffer

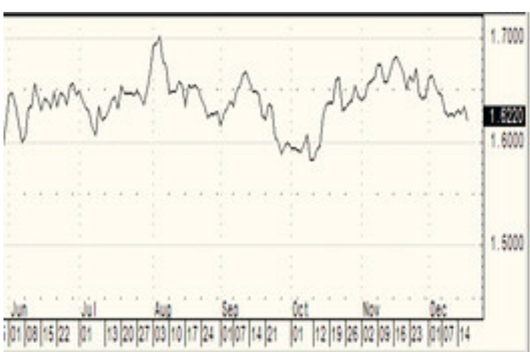
Introducing Nicholas Hastings, a columnist for Dow Jones Newswires

For months, the pound has been able to shrug off concerns about the poor state of the U.K. economy, with the currency still getting support from risk-hungry investors.

Even news that Dubai World was reneging on $30 billion of debt repayments–much of it owed to U.K. banks–failed to seriously knock the U.K. currency much lower.

However, if currencies are now being driven more by interest rate differentials and less by risk appetite, as events this week suggest, then sterling could be even more vulnerable to heavy losses than it was before.

The following chart shows the pound's steady performance in recent months.



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The euro is already falling against the dollar on the assumption that euro-zone interest rates will start to rise well after those of the U.S.

Chances are that rates in the U.K. will start to rise even later than that.

Once this timing starts to be discounted by financial markets, then the pound will more than likely find itself falling into third place against the other two major currencies.

For the moment, though, an improvement in the latest RICS house price index, an upturn in inflation and the first fall in the jobless claimant count since February last year have helped to inject some optimism over the U.K. economic recovery.

At the same time, poor data from the euro zone alongside worries about the euro zone's own banking problems have helped to push the pound higher against the euro.

This should soon reverse.

Not only are concerns about the euro zone likely to subside, as recent strong purchasing managers' survey data from the region suggest, but optimism over the U.K. economy is unlikely to last.

The RICS data may have suggested that the U.K. housing market is stabilizing, but with new buyer enquiries and activity easing off, this hardly bodes well for some sustainable rebound in house prices in the longer term.

Similarly, the unexpected sharp rise in inflation up to 1.9% last month isn't the start of a sustainable trend. Yes, a combination of higher energy prices and a return in the value-added tax level to 17.5% from 15% may help to lift the rate as far as 3% in coming months. But the rate will soon subside again, leaving the Bank of England able to concentrate more on promoting growth rather having to worry about rising price pressures.

Even the unexpected fall in jobless claimants should prove of little consequence as far as policy is concerned. The improvement appears to have come largely from part-time jobs being filled by a much more flexible workforce. And with more cost cutting still likely early next year, "a second leg downturn in the labor market remains a key risk for 2010," warned Vicky Redwood, U.K. economist with Capital Economics in London.

If so, then the Bank of England is hardly likely to compete with either the Federal Reserve or the European Central Bank, as both of these show signs of edging towards an exit from their ultra-cheap monetary policies that will push the yields of U.S. and euro-zone short-term bonds even higher against those in the U.K.

Early today, the pound was being pushed lower against the dollar after the FOMC showed a slightly more hawkish stance at Wednesday's policy meeting. Although rates are expected to remain unchanged for an extended period, the central bank confirmed that it will start exiting its ultra-loose credit conditions in February.

The pound fell to $1.6225 by 0745 GMT from $1.6329 late Wednesday in New York, according to EBS.

The euro fell to $1.4398 from $1.4531 with news of the latest downgrade of Greek debt by S&P adding to the single currency's woes. The euro was also down at Y129.14 from Y130.45. The dollar was down at Y89.67 from Y89.78 after failing to make a sustained break over Y90.