IJNRD.ORG ISSN : 2456-4184
INTERNATIONAL JOURNAL OF NOVEL RESEARCH AND DEVELOPMENT (IJNRD) | IJNRD.ORG
An International Open Access, Peer-reviewed, Refereed Journal

To what extent have macroeconomic events impacted the strength of the Great British Pound (GBP) in recent years and what is expected for its future

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Abstract

The aim of this paper is to analyse the events that have taken place in the UK economy and the subsequent effect they have had on the Great British Pound (GBP), which is the oldest currency that we still have in use. In line with this, the first half of the paper reviews the existing knowledge with regard to exchange rates, exchange rate regimes and the myriad of factors that impact the value of a currency and an economy. The paper then particularly focuses on the various political, social, and economic events that have taken in the UK in the years; 2016 i.e. the year Brexit came into form, 2020 i.e. the year of the global pandemic and 2022 i.e. the year of three prime ministers. The impact that these events have had on the GBP and the subsequent effects on the stakeholders involved are thoroughly discussed in the paper. The aforementioned is facilitated by the use of appropriate economic theories and knowledge.

Keywords: Exchange Rates, Great British Pound (GBP), Political Events

Introduction

The pound sterling is the oldest currency to still be in use (CFI, 2020). They say things get finer as they age. But, is that true in the case of the pound?

An exchange rate is the rate at which one currency will be exchanged for another (Chen, 2022). Exchange rates are impacted by a myriad of factors and events that take place in the macroeconomy. For instance, inflation and interest rates are repeatedly observed as two of the most prominent influencers of a country's exchange rate

(HSBC, 2020). Regardless of the factors influencing a currency, the strength and stability of a currency are vital for several stakeholders, including both local and global businesses, consumers, and the government.

The last few years have been particularly unsteady and eventful for economies everywhere, specifically, the United Kingdom. 2016, for example, saw the vote open for one of the most impactful events in British Economic history i.e. Brexit. The following years have seen the Great British Pound (GBP) fluctuate greatly. This fluctuation has been even further triggered by other events between the years 2020 and 2022, such as the COVID-19 pandemic, the death of a monarch, and continuous political instability.

This research paper aims to provide a thorough and in-depth analysis of the United Kingdom's macroeconomy over the past couple of years and in doing so, evaluate how a myriad of events have caused the GBP to fluctuate. In line with the aforementioned, the research question to be answered is **"To what extent have macroeconomic events impacted the strength of the Great British Pound (GBP) in recent years, and what is expected for its future?"**

Literature review - Exchange rates and their determinants

Exchange rates are defined as the price at that one nation or economic zone's currency can be exchanged for another currency. If you are travelling to another country, you need to "buy" the local currency. Just like the price of any asset, the exchange rate is the price at which you can buy that currency (Investopedia, 2019).

In reality, there are only two types of exchange rate regimes that can be followed in nations - the *fixed regime* and the *floating regime*. However, these two systems have several variations within them. Each of these systems is commonly associated with the degree of liberalization of the underlying economy. A brief explanation of both these regimes is provided below :

Floating Rate vs. Fixed Rate

A fixed exchange rate is a regime established by a country to tie its currency to the currency of another country or a commonly traded commodity like gold or oil. That country's central bank will then buy and sell its currency against the pegged currency to maintain a consistent exchange rate. A fixed exchange rate helps to ensure the smooth flow of money from one country to another. It assists smaller and less developed countries to attract foreign investment. An example of a pegged exchange rate is the Danish krone, which is pegged to the euro so that 1 euro equals 7.46 kroner (the currency of Germany) but can fluctuate between 7.29 and 7.62 kroner per euro (Reserve Bank of Australia, 2020).

A floating exchange rate, on the other hand, permits a currency to rise and fall by supply and demand in an open market. Since market forces control this kind of exchange rate, it is believed to be "self-correcting" (Investopedia, 2019). Most modern economies such as the USA, India, Australia, etc have floating exchange rates because their imports, exports, and domestic trades are robust enough to maintain a healthy economy. If supply surpasses demand that currency will fall, and if demand surpasses supply that currency will rise.

Currency strength

Let us take an example to explain a currency that is 'appreciating' or becoming stronger. Let us assume that earlier for each GBP we had to pay 100 Rupees but now we only have to pay 97 Indian Rupees for each GBP. In this example, the value of the Indian Rupee has appreciated or we can say that it has become stronger.

To explain the other side of the coin let us assume earlier for each GBP we had to pay 100 Indian Rupees but now we must pay 103 Rupees. In this example, the value of the Indian Rupee has depreciated or we can say that it has become weaker.

There are many benefits of a strong currency for a nation. Some of these are explained briefly below (Elam, 2012):

- *Lower Inflation* - When a currency depreciates, less foreign exchange can be bought resulting in imports becoming costlier and exports becoming cheaper. This may lead to imported inflation and greater demand-pull inflation resulting from a reliance on domestic goods. On the other hand, when a currency appreciates, the inflation levels tend to be lower and more stable.
- *Acquisition Commodities* - A company from a country with a strong currency can buy a similar company or a supplier, in a country that has a weak currency.
- *Low-funding costs for the government* - Flows from outside the country oftentimes go into local government bonds when there is a strengthening currency. The aforementioned may lower yield and therefore allow the government of a country with a stronger currency to raise money at lower rates.
- *Sense of wealth* - Citizens of a country with a strong currency find it cheaper to travel abroad, which instils a sense of wealth within them.

However, regardless of how much the government and/or central bank of a country would like to maintain a strengthened currency, there are several interconnected factors that influence currencies at all times. Some of the most commonly noted in the literature are as below:

- *Inflation* - Inflation refers to the general increase in prices within an economy over time. A shallow rate of inflation does not guarantee a favourable exchange rate for a country, but an extremely high inflation rate is very likely to impact the country's exchange rates with other nations negatively (Investopedia, 2022).
- *Interest rates* - Higher interest rates help uplift a currency given the fact that foreign investors can get a higher return by investing in that country. This insinuates that higher interest rates attract foreign capital, therefore, naturally causing exchange rates to rise. Another viewpoint to be looking from at this determinant of exchange rates is that as the demand for a currency rises due to the high-interest rates it has to offer, so does its value (Twin, 2020).
- *Economic health* - Foreign investors inevitably seek out stable countries with strong economic performance in which to invest their capital. A country with such positive attributes will draw investment funds away from other countries perceived to have more political and economic risk (Twin, 2020). If an economy is doing well, it is likely to attract a greater degree of foreign investment which helps lower inflation and subsequently strengthen the exchange rate.
- *Political stability* - A strong government with a well-established rule of law attracts investment and thus boosts a currency. A country with stable financial and trade policies does not give any room for uncertainty in its currency. But, a country prone to political commotion may see a downfall in exchange rates (Barrington, 2011).
- *Speculation* - Another potential influencer of exchange rates is currency speculation. This may be understood as a simple concept of demand and supply wherein if there is an expectation of a change in the price of the currency in the future, there would be a direct effect on its demand. Some examples of this could be an upcoming election, a change in economic policies, etc. However, these effects are typically short-term, and other factors tend to be more important in the long run.

<u>**An Introduction to the GBP**</u>

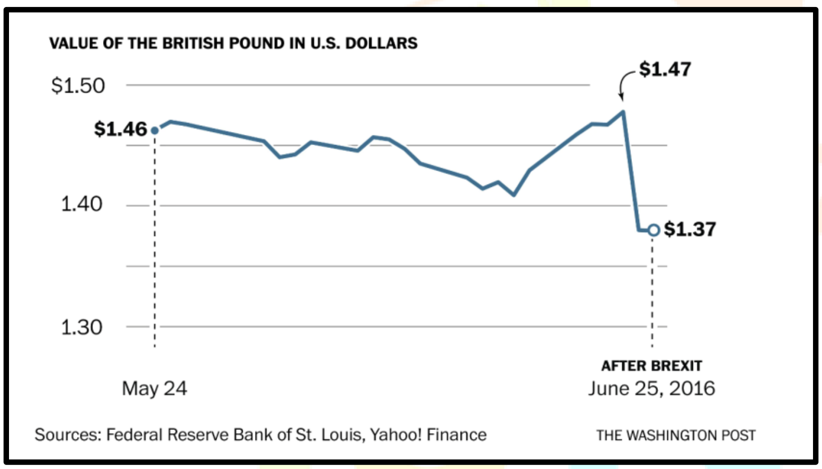
GBP is the official currency of the United Kingdom, the British Overseas Territories of South Georgia, the South Sandwich Islands, the British Antarctic Territory as well as the U.K. crown dependencies i.e. the Isle of Man and the Channel Islands. In the world, the GBP is one of the most traded currencies just behind the US dollar, Japanese yen, and euro.

The currency has a great history. In 1707, England and Scotland decided to unite and form a single country resulting in the British pound being made the official currency of the UK. However, it is believed that the very first creation of the British pound in the form of money was done in 760. The British pound is, therefore, said to be the oldest currency which is still a legal tender and since 1992 follows a floating exchange rate regime (Kenton, 2020).

The following sections of the paper will be analyzing some of the most significant economic and political events that have taken place in the UK over the last few years and evaluate how they have impacted the GBP.

GBP in 2016

The year 2016 was a complete rollercoaster for the pound as a result of several economic and political events that took place. The year did start off as normal as anticipated, however, things took a turn on 23 June 2016. In 2013, Prime Minister David Cameron promised a national referendum on European Union membership with the idea of settling the question once and for all. The options offered to voters were broad and vague — Remain or Leave. On June 23, 2016, the UK residents took to the polls and the Leave campaign emerged with a majority of 52% (Higgins, 2013).



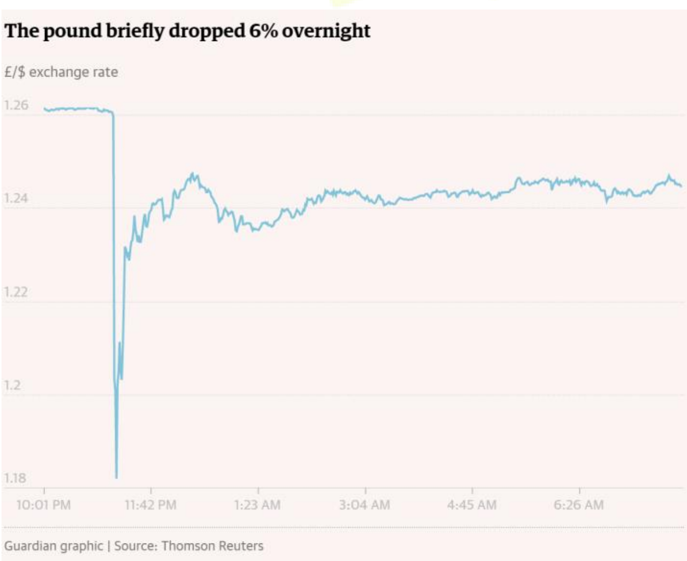
The outcome of the Brexit vote impacted the country and the rest of the world in several ways. The GBP, particularly, took a great hit with the value slumping to a 31-year low on currency markets and heading towards its biggest one-day loss in history. The sudden drop can be seen in the graph on the left (Soffen, 2016). During this period, several investors started to lose confidence in Britain's future outside the European Union resulting in a piling out of the currency and a low of $1.2796 being hit (Allen, Treanor, Goodley, 2016).

The lower levels of confidence started to spread amongst the majority of the population like wildfire and were greatly triggered by the ongoing speculation regarding the impact of Brexit on the various stakeholders of the UK economy. The main argument highlighted was the complications that would inevitably arise for U.K.- EU cross-border relationships (Scott, 2021). The aforementioned would entail new administrative and regulatory burdens including local licenses, visas, border checkpoints, personnel relocation, etc., affecting all types of businesses.

The agricultural and fishing industry, for example, was set to face havoc in light of changing regulations and border controls that would impact agricultural exports and imports. Fishers' lobby groups were aghast that the deal would end the practice of quota swapping between British and EU vessels, meaning that in some cases UK fishers may be limited to smaller catches. All the aforementioned would inevitably impact all the stakeholders including the fishers, farmers, distributors, grocery store chains, restaurants, and consumers. Furthermore, even the financial services companies had started to recognize that Brexit likely would require the relocation of significant operations and personnel from London to EU locations and would mandate local registration and licensing to conduct business in the EU. With regard to sourcing adjustments, larger manufacturers with complex products containing parts acquired from other areas of the world were not prepared to handle the administrative burden - in the form of both time and money - of sorting out rules of origin (Makortoff, Kowelle, Topham, Wood, Jolly, 2020).

As the UK economy managed to stumble up to August, The Bank of England cut interest rates for the first time in more than seven years in a bigger-than-expected package of measures designed to prevent a post-Brexit recession. The Bank cut official interest rates to a new record low of 0.25% from 0.5% and signalled they would be reduced further in coming months as the economic fallout from the vote to leave the EU became clearer. The move brought relief to borrowers but angered savers who had been getting low returns for years thanks to rock-bottom interest rates (Allen, Elliot, 2016).

While this interest rate cut helped the economy somewhat, just as people were starting to sigh out in relief, the pound mysteriously crashed on October 7th. On 6th October, the GBP was trading at $1.26. Then, just after midnight, it slumped as low as $1.15 before bouncing back to $1.24 as can be seen in the graph on the left (Davies, 2016). Analysts pointed to possible causes including rogue computer trades, an accidental "fat finger" transaction (a trade wherein a trader mistakenly enters an incorrect order, such as buying or selling too many shares or entering the wrong price), and tough comments from the French president, François Hollande, on Brexit negotiations (Chu, 2017).



The BIS ultimately concluded that the October crash was not a unique or unprecedented event but "a new data point in what appears to be a series of flash crash events occurring in a broader range of fast electronic markets than was previously the case in the post-crisis era". It also warns that such events "have the potential to undermine confidence in financial markets and hence impact the real economy" (Chu, 2017).

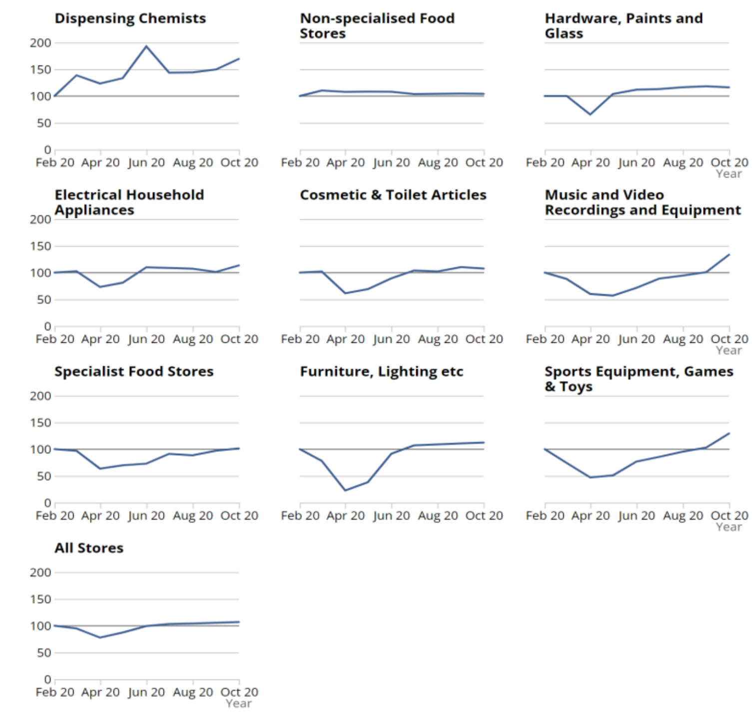
Post all these turns and turbulences the British economy endured in 2016, it still managed to end the hectic year on a positive note as the pound managed to strengthen after the announcement that the UK could not leave the EU in the absence of a parliamentary vote.

GBP in 2020

The years following 2016 were times of relatively slow growth for the UK economy. For instance, UK gross domestic product (GDP) increased by 1.7% between 2016 and 2017 which is much lower than anticipated and would have been higher had the UK chosen to remain in the EU (ONS, 2018). In 2018, the growth of the UK economy slowed down further and reached its lowest in 6 years (Reuters, 2019). The economy grew a marginal 0.1% in 2019 and saw no growth at all in the final three months of the year, as manufacturing contracted for the third quarter in a row and the service sector slowed around the time of the election (ONS, 2020).

The year 2020, was indeed one of the most eventful for the British economy (as well as global economies) as the pound tried its best to keep an upper hand over the multitude of bad news which poured in from all over. The pound got off to a solid start in 2020 as there was relief that the uncertainty surrounding Brexit seemed to be drawing to a close - the UK had finally entered a transition period for leaving the EU and the end was in sight, even if no deal had been struck on yet. However, this soundness of the GBP came to an abrupt end towards the end of February as the currency plummeted as soon as The Bank of England hinted to cut interest rates. The Bank of England cut interest rates on March 19 again in an emergency move. It was the second cut in interest rates in just over a week, bringing them down to 0.1% from 0.25% (Islam, 2020). Some homeowners' mortgage repayments were made cheaper as a result of these cuts. However, on the other hand, the rate cut was once again bad news for savers - with the Bank pumping more money into the economy, there was even less incentive for banks to offer decent rates to savers to gain deposits that they could then lend out to others.

On March 11, the outbreak in China was officially declared by WHO to be a global pandemic. The pound dropped to its lowest level since 1985 on March 19, slumping to $1.14 (Allen, 2020). Throughout April, the pound laboured against its rivals, despite a weakening dollar due to the uncertainty around PM Borris Johnson’s health, who was admitted into intensive care after contracting Covid-19. The pound came under more pressure in June, slipping further against virtually all major currencies. The main reason behind the pound’s poor performance was the continuous feeding of poor economic news to the population - the headlines were filled with reports of job losses across the UK economy, with the retail and aviation sectors being particularly badly affected as thousands of redundancies and several major insolvencies were announced. The poor performance of some major industries throughout the first wave of COVID-19 can be seen in the graph below (ONS, 2020)



Source: Office for National Statistics – Monthly Business Survey - Retail Sales Inquiry

The aforementioned fuelled a great deal of speculation and subsequent underconfidence in the health of the economy impacting many stakeholders including foreign investors who were discouraged from putting their money in the GBP.

Overall, the UK economy, measured by gross domestic product (GDP), shrank by a record 19.8% in the second quarter (April to June) of 2020, following the start of the first lockdown on 23 March (ONS, 2020). Services such as hospitality – including pubs, restaurants, and hotels – recorded almost no output in April and May, but industries such as information and communication, where staff could largely work from home, saw little change compared with February. The pound weakened against the euro between February and April – with the GBP/EUR pair falling 4.69%. This is an indication that investor confidence in GBP was much lower than it was for EUR as the initial onset of the coronavirus began to sting the markets.

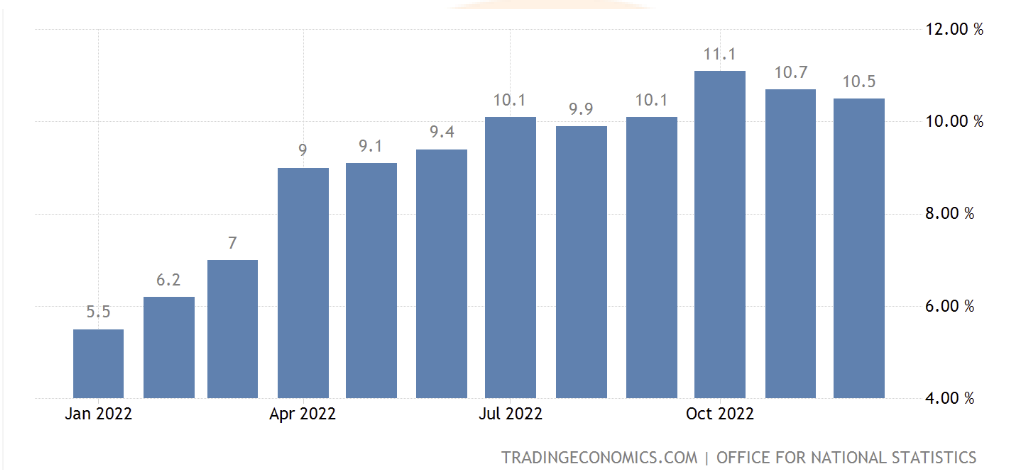
In September 2020, PM Boris Johnson unveiled a new system of region-specific lockdowns to mellow down the spread of Covid-19. The announcement heaped further pressure on an already struggling economy to re-emerge whilst further reducing hopes for the GBP to bounce back. Observing the low levels of confidence, fears of mass unemployment and anger over the lack of government support in the economy, on October 22, 2020, UK Chancellor Rishi Sunak unveiled a multibillion-pound package for businesses and workers (Partington, Stewart, Murphy, 2020). Under this package, employees of UK firms which were forced to shut by law because of covid-19 got two-thirds of their wages paid for by the government. The scheme was not only generous to the workers but also to the employers as it reduced the level of employer contributions required to access the support to 5% of a worker's usual wage, down from a previous level of 33%.

With regard to the performance of the pound in the month of November, it was relatively better than in previous months. The aforementioned was due to a triad of reasons including the rising global risk appetite in the wake of the US election – which Democratic Party challenger Joe Biden was deemed to have won –, several advancements in the race to find a vaccine for Covid-19, and rising forecasts that a Brexit deal would be agreed upon before the transition period ran out.

Finally, there was a breath of relief towards the end of the turbulent year as in December, the economy grew by 1.2%, after shrinking greatly in previous months, as some restrictions eased (Hindustan Times, 2021). The easing up of restrictions was backed by AstraZeneca's COVID-19 vaccine being approved for emergency supply in the UK, with the first doses being released on December 30.

GBP in 2022

Had it been possible to compare the greatness of events in a year, 2022 might have just won the contest for Britain! In terms of a quick overview; the cost of living increased sharply across the UK during 2021 and 2022 with the annual rate of inflation reaching 11.1% in October 2022 (as can be seen in the graph below), a 41-year high, before easing in subsequent months (Wilson, Barton, Bolton, Keep, Harari, Francis-Devine, 2023).



This inflation had the most significant impact on energy prices, with prices of gas, for instance, increasing to record levels and being further fuelled by cuts in Russian supply. As electricity prices are linked to gas prices, they too followed a similar trend with several UK households finding themselves in a crisis. Electricity aside, the cost of living crisis left several people struggling to afford even basic necessities such as food with many food bank charities across the country reporting an increase in demand - The Trussell Trust, for instance, reported that in

April-September 2022 they provided almost 1.3 million emergency food parcels, a third more than in the same period in 2021 and 50% more than pre-pandemic levels.

With regard to analysing the state of the pound in the year 2022, the currency value managed to stay at a constant rate for January and February with the GBP/USD rate being at 1.34 (Statista, 2023). However, an unchanging currency did not imply stability in the country. Instead, on January 12, PM Borris Johnson admitted to attending the party held at 10 Downing Street in May 2020 and apologized to the House of Commons. This event is what marked the beginning of the downfall of the Conservative government. Further confidence was lost in the PM and his government as another scandal regarding Tory MP Neil Parish rolled leading to him announcing his step down after admitting to reports that he had watched pornography in the House of Commons (Doherty,2022).

Given all the events that had taken place in the earlier months of the year, on June 6, MPs held a Vote of confidence in Boris Johnson. More than 40 percent of the parliamentary Conservative Party voted that they had no confidence in the prime minister. However, Johnson managed to win the vote by 211 to 148 (Doherty,2022). On 5 July, Health Secretary Sajid Javid and Chancellor Rishi Sunak's resignations triggered a tidal wave of departures over the subsequent 48 hours. Two days later Boris Johnson announced he would stand down after dozens of ministers resigned. The pound continued to drop and plummeted to $1.16 in August due to the constant disruptions in UK politics. On September 5, Liz Truss won the Conservative leadership contest and became prime minister. Liz Truss vowed to deliver a "bold plan to cut taxes and grow our economy". On September 8, the entire world mourned the death of the long-standing monarch of the UK, Queen Elizabeth II.

In line with her mission, on September 25, the mini-budget was announced by the Chancellor of PM Liz Truss' government Kwasi Kwarteng. This budget had several implications - it was estimated that the tax cuts announced in the mini-budget would result in a £45 billion hole in finances for the public by 2026-2027. Furthermore, Kwarteng cut stamp duty which meant the maximum value of a property on which first-time buyers' relief can be claimed would also increase from £500,000 to £625,000. The government said these measures would take more than 200,000 buyers out of paying for stamp duty altogether. The impact of this announcement on the value of the pound was catastrophic - the currency plunged nearly 5% at one point to $1.0327, its lowest since Britain went decimal in 1971, as belief in the UK's economic management and assets evaporated (Wearden, 2022).

As October came around, Liz Truss sacked her chancellor and long-time ally Kwasi Kwarteng and replaced him with Jeremy Hunt who reversed almost all Liz Truss's tax measures. On October 20, after not even 50 days in office, Liz Truss became Britain's shortest-serving prime minister with her announcement that she would step down as leader of the Conservative Party and prime minister, following irreparable damage caused to her leadership by her mini-Budget the previous month. On October 24, Rishi Sunak won the race to be the leader of the Conservative Party and became Britain's next prime minister - the third of the year. And with this crucial event, the year was finally able to come to a non-dramatic end.

Now, writing from 2023, the British economy has thus far avoided recession and posted stronger-than-expected growth in January. Outlooks from the major economic forecasters have now been updated, with the OBR no longer projecting a technical recession — defined as two consecutive quarters of negative growth — in 2023. The country's fiscal position has drastically improved, due in large part to a sharp fall in gas prices, and further fiscal support from the government. Yet, the picture is still not entirely rosy. The U.K. remains the only G-7 major economy not to have recovered its pre-Covid level of output, and inflation is still hovering in double digits (Smith, 2023). British households continue to contend with high food and energy bills, while workers across a range of sectors have launched mass strike action in recent months amid disputes over conditions and pay.

Conclusion

The GBP is one of the oldest currencies to have existed and in the last couple of years, it has seen its fair share of ups and downs. The ultimate goal of this paper was to analyze and evaluate most of the major events that have taken place over the years 2016, 2020 and 2022 and how the pound has fallen and risen as a consequence of those events. Another point thoroughly focused on is the impact that each of these events has had on the stakeholders of the economy.

From the literature review, it was deduced that there are two kinds of currency regimes that a country might adopt. In the case of the UK, the GBP has a floating exchange rate system wherein its value is greatly defined by market forces. As discussed in the paper, currency strength is impacted by a myriad of factors and some of those include interest rates, inflation, economic health, political stability, and speculation. When focusing on the fluctuations in the strength of the GBP, particularly, the currency took a dire hit in the year 2016, as a result of speculation and a lack of confidence post the announcement of the Brexit vote. In 2020, Covid - 19 was the main headline worldwide and impacted all economies hugely with the UK taking one of the hardest hits - the GBP, once again, saw a lot of fluctuations this year but ultimately ended on a stronger note than what had been observed for several months. In 2022, the country witnessed one of the most turbulent times, politically. The mini-budget introduced under Liz Truss's government specifically caused one of the biggest hits to the GBP.

On the whole, it can be said that macro events have impacted the strength of the GBP to a great extent in recent years. That being said, the factors affecting an economy are ever-changing and we can only ever predict events and consequences but never exactly know for certain. Ultimately, the GBP is the oldest currency in existence and for it to regain the reputation it has always upheld, it must be driven in the direction of stability so that the stakeholders do not suffer as much as they have in the past few years.

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