MARKETS

Snapshot

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British pound rally is led by fears over euro but lacks fundamental grounding

The Great British pound (GBP) has advanced by 6.5 per cent against Lithuanian litas (LTL) year to date almost reaching its highest value against LTL since September 2008. This rally is explainable by weak euro (which LTL is pegged to) as treasury departments in several global companies' started keeping their cash in GBP instead of euros as an answer to the problems in the euro zone. However, from the economic fundamentals point of view, GBP does not have many reasons to appreciate against the euro much further unless the euro crisis escalates.

First of all, Bank of England has recently started another round of quantitative easing and plans to inject around GBP50bn into the system. In comparison European Central Bank did not undertake monetary stimulus actions since the long-term interbank loans offerings this February.

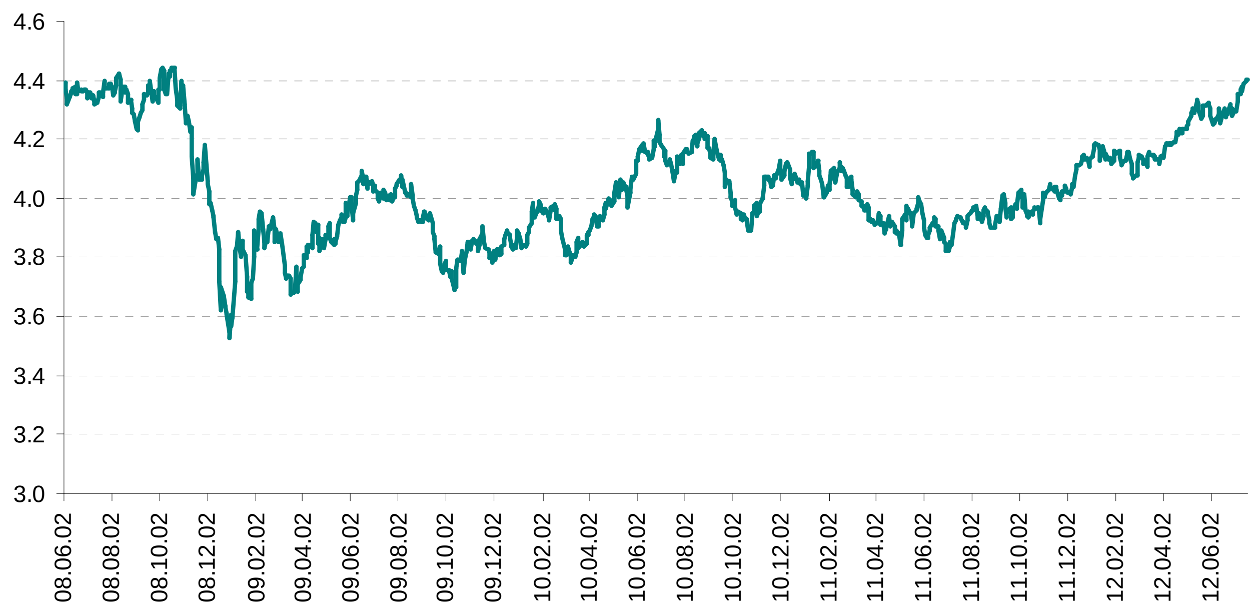
Secondly, central bank policy rates (0.5 per cent) in Britain are smaller than in Europe (0.75 per cent) while consensus expected inflation for 2012 is slightly higher in Britain as well (2.7 per cent versus 2.3 per cent).

Thirdly, Great Britain's current account balance with the euro zone is negative (it currently stands at c. –GBP2.7bn) and has been negative for the last 20 years. In addition, consensus GDP growth forecasts for 2012 stand at 0.1 per cent growth in Britain and -0.5 per cent contraction in the single currency area. Thus, Britain is suffering an economic slowdown as well.

In theory all these factors should make GBP less attractive compared to the euro. Hence in the long run fundamentals should weight against the GBP unless ECB reduces key policy rates and/or starts its printing press. However, current adversity towards the single currency might lead to stronger GBP in the short run especially if the euro crisis escalates.

This means more competitive Lithuanian and Latvian exports to and possibly larger amounts of expats' remittances from the Great Britain.

Figure 1: GBP versus LTL (litai per 1 GBP)



Best regards,

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