

Inflation Falls and Pound Gains in Strength

“Inflation on the rise again to 2.8% as weak pound makes imports pricey.”

If you are thinking that this article is slightly out of date, then you would be right! This headline came from a paper in February 2013 – two years ago.

Today, we see a different picture altogether. At the time of writing this, the rate of inflation is 0% and sterling stands at a seven year high against the Euro, at $\pounds 1 = \text{€}1.35$. The Euro has seen a fall in its value over a period of several months, linked to a fall in the level of economic activity across the Eurozone and uncertainties with Greece.

The Governor of the Bank of England, Mark Carney, also spoke of the potential for UK inflation rates to turn negative for a while, as the price of oil continues to remain at a record low and the strength of sterling causes a fall in import prices from across the Eurozone. The Eurozone is the UK's largest trading bloc partner, with more than 50% of the UK's imports and exports being with the trading bloc.

So, who wins and who loses from a strong rate of sterling against the Euro? The acronym SPICED can be used to consider this – Strong Pound, Imports Cheap, Exports Dear.

Firms which import raw materials and component parts into the UK will see a real financial benefit in terms of lower relative prices. For example, an engineering firm importing a component for $\text{€}1000$ will pay $\pounds 740.74$, assuming an exchange rate of $\pounds 1 = \text{€}1.35$, whereas when the rate of exchange was $\pounds 1 = \text{€}1.22$, the same product cost them $\pounds 819.67$. Therefore, there is a saving of $\pounds 78.93$ on that one component alone.

However, the reverse is the case of a UK firm that sees its largest markets within the Eurozone area. Here, the strength of Sterling poses a real threat to such a firm as the relative Euro price of its goods continues to increase.

The true impact upon firms will not become clear until they report profits at the end of the year. In 2014, Sterling was strong against the US Dollar and this has recently led to Rolls Royce announcing a profits warning in February 2015. Interestingly, the company apportioned some of the declining sales to the low price of oil, which is causing uncertainty amongst some of Rolls Royce's customers. It also blamed the strength of Sterling against the US Dollar in 2014 for a fall in revenue estimated to be in the region of $\pounds 500$ million.

Of course, there are always winners too. UK consumers planning their summer holidays in Europe will benefit from their money going even further. The Post Office report that a person exchanging $\pounds 500$ will gain $\text{€}67.5$ or $\pounds 52$ more than they would have done in February 2014 and hotel breaks charged in Euro are becoming relatively cheaper. The package tour operators are seeing margins increase as they price their services in Sterling and often do not pass on the exchange rate fluctuations to their customers. This spells less positive news for UK tourist destinations, which see a declining proportion of domestic customer sales and a fall in revenues as the UK becomes less competitive for European tourists.

