Forex Focus: P Is For Pound...And For Politics

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A DOW JONES NEWSWIRES COLUMN

LONDON (Dow Jones)--Politics, as much as the economics, is now starting to threaten the pound.

Sterling spent much of the summer sailing quite happily.

The coalition's pledge to slash public spending had removed the threat of a credit rating downgrade.

Also, economic data suggested that although the U.K. economy was slowing, it might well be in better shape than expected.

But, as summer turns to autumn, so the pound's prospects are turning sour.

See how the pound's rally is running out of steam:

http://www.dowjoneswebservices.com/chart/view/4652

On the economic side, growth may be stabilizing at lower levels for now but with house prices still falling, wage growth at minimal levels, unemployment remaining high and consumer confidence still very weak, there is a growing risk that deflation could start to loom.

Within the Bank of England, there is hardly an agreement on what to do. At one extreme is Adam Posen calling for more quantitative easing to keep a double-dip recession at bay. On the other side is Andrew Sentance, the well-known hawk, who continues to call for an interest-rate hike.

As the global recovery falters, the debate over quantitative easing is hardly exclusive to the U.K.

Japan has continued pumping more money into its system and U.S. Fed is widely expected to announce further bond purchases, in one form or another, when it meets in November.

Even the European Central Bank could be forced to follow suit if concern over the sovereign debt crisis continues to depress investor sentiment.

All this means that the U.K. is not the only country to face a slide in yields and the pound is not the only currency to lose its attraction.

But, it is politics that could be the real killer.

As the Oct. 20 date for the coalition's review on public spending gets closer, sterling investors could start to lose their nerve.

The size of the cuts, amounting to a 25-40% reduction in spending by most government departments, is unprecedented in the U.K.'s post-war history.

The whole exercise may well have attracted the admiration of the International Monetary Fund but the cuts will start to bite early next year, just when the country is already at a low ebb.

For the coalition this is hardly good news--and its ability to deliver the cuts will be called into question.

First, support within the carefully-balanced government of Conservatives and Liberal Democrats is hardly universal. Defense Secretary Liam Fox has already been making front page headlines this week about his opposition to cuts he is being asked to make to the army.

Opposition by other ministers is only likely to grow as the detailed extent of the spending review becomes known.

But it the government's ability to persuade the public that could be the real issue.

Even before the opposition Labour Party signalled a swing back to the left by electing the union-backed Ed Miliband as its new leader this week, the country's major unions have been threatening coordinated action to cripple the country with strikes.

So with the success of the spending cuts still very much up in the air and the prospects for the economy and rates still looking so uncertain, it is hardly surprising that sterling's sunny summer is turning very cloudy.

The pound was up early Thursday as Nationwide reported that house prices edged up by 0.1% this month even though they were down 1.0% in the third quarter.

Overall, currencies were being driven by a deterioration in risk sentiment as speeches by several Federal Reserve officials showed a division within the central bank over whether or not to pursue more quantitative easing.

Meanwhile, news that Moody's had downgraded Spain's credit rating one notch to Aa1 and that Ireland is pumping EUR29.3 billion in Anglo Irish Bank, not quite as much as the EUR35 billion that some had feared, helped to lift the euro from its lows of the day.

By 0645 GMT, the pound had risen to $1.5834 from $1.5787 late on Wednesday in New York, according to EBS.

The euro was down at $1.3591 from $1.3630 but up from its low at $1.3562.

The single currency was also down at Y113.15 from Y114.07 while the dollar fell to Y83.24 from Y83.70. The pair made it down as far as Y83.19 but remains highly nervous that the Bank of Japan will start to intervene under Y83.00.

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