

## **The UK's Exchange Rate Policy: A Critical Assessment and Recommendations for Enhanced Effectiveness.**

The exchange rate system is a crucial determinant of a nation's economic stability and global competitiveness. The United Kingdom (UK) operates under a floating exchange rate system, where the value of the British pound (GBP) is dictated by market forces of supply and demand within the foreign exchange (Forex) market (Sodersten, 1994). Unlike fixed or pegged exchange rate systems, the UK government and the Bank of England (BoE) do not directly intervene to maintain a specific exchange rate. Instead, the pound's value fluctuates based on various economic indicators, investor sentiment, and global financial developments.

The UK's exchange rate system relies on open market mechanisms, where supply and demand determine currency movements. Increased demand for GBP leads to appreciation, while decreased demand—due to economic downturns, uncertainty, or lower interest rates—causes depreciation (Faudot, 2022). Unlike fixed or managed systems, the UK government does not directly stabilize the pound. However, the BoE indirectly influences exchange rates through monetary policy, such as interest rate adjustments and inflation control (Dellas, 2006). Higher interest rates attract foreign investment, strengthening the pound, while lower rates weaken it. In crises, the BoE may intervene to restore confidence. Exchange rate fluctuations are driven by interest rates set by the BoE's Monetary Policy Committee (MPC). The base rate influences borrowing costs, savings returns, and capital flows. Higher rates attract foreign investment, boosting GBP demand and strengthening the currency, while lower rates reduce asset appeal, leading to capital outflows and depreciation (Morina, 2023).

The UK's open financial system heightens the pound's sensitivity to interest rate changes, as global investors respond to yield differentials. If the BoE raises rates while others hold steady, arbitrage opportunities boost GBP demand. However, expectations of future rate changes can be

as impactful as actual policy shifts, with BoE forward guidance shaping investor behavior in advance. Inflation both influences and results from exchange rate movements (Boubaker, 2024). In a floating system, a currency's value depends on its purchasing power. High inflation weakens the pound by reducing competitiveness, while low inflation promotes stability, boosting investor confidence.

Beyond inflation, economic indicators like GDP growth, employment, and trade balances shape exchange rates. Strong GDP and labor markets attract investment, boosting GBP demand. A current account surplus supports the pound, while deficits weaken it. Given the UK's reliance on foreign capital, its currency is highly sensitive to investor sentiment. In a floating exchange rate system, market forces determine currency value, enabling automatic adjustments. A trade deficit weakens the pound, making exports cheaper and imports more expensive, naturally reducing imbalances. For example, if the UK imports more than it exports, rising demand for foreign currencies depreciates the pound, boosting exports and curbing imports, promoting economic stability.

During downturns, a weaker currency boosts exports, while in inflationary periods, appreciation lowers import costs and stabilizes prices, enhancing economic adaptability. On Black Wednesday (16 September 1992), the UK's forced exit from the ERM led to pound depreciation, improving exports and aiding recovery, demonstrating the benefits of exchange rate flexibility (Barry Eichengreen, 2022). Under a floating exchange rate, the UK requires fewer foreign exchange reserves, as market forces determine the pound's value without government intervention. Prior to this system, the UK relied on fixed exchange rates, like Bretton Woods, necessitating large reserves to maintain stability. This led to economic challenges, including devaluations in 1949 and 1967 to address balance of payments issues. The shift to a floating exchange rate reduced the need

for large-scale interventions and reserves, enabling more effective allocation of resources toward infrastructure, healthcare, and education, supporting long-term growth. For example, the UK recently announced a £20bn increase in investment through borrowing (Financial Times, 2024). Additionally, minimizing reserves avoids low-yield investments like U.S. Treasury bonds, promoting more efficient capital allocation.

A floating exchange rate acts as a buffer against external shocks. If global demand for UK exports falls, the pound depreciates, making UK goods cheaper and boosting exports. During the 2008 Global Financial Crisis, the pound fell from \$2 to \$1.40 per GBP (Choudhry, 2015), enhancing export competitiveness and supporting the economy. A weaker pound also attracted foreign investment and boosted tourism by making the UK more affordable.

Monetary policy autonomy is a key advantage of a floating exchange rate system, allowing the UK to adjust its monetary policies to domestic economic conditions without the obligation to defend a fixed exchange rate. This flexibility proves crucial during economic crises or inflationary pressures. As the British pound (GBP) is not pegged to another currency, the BoE can independently modify interest rates and implement quantitative easing or tightening as necessary. A notable example occurred during the COVID-19 pandemic (2020-2021), when the UK economy contracted sharply due to lockdowns and reduced consumer demand. In response, the BoE lowered interest rates to a historic 0.1% and introduced a £895 billion quantitative easing program to inject liquidity into the economy and support businesses (UK Parliament, 2021). Under a fixed exchange rate regime, the UK would have been constrained by the need to stabilize the currency, potentially limiting its ability to reduce interest rates or expand monetary policy. This could have exacerbated the downturn, as observed in countries struggling to balance monetary stimulus with exchange rate stability. Moreover, monetary policy autonomy enables the UK to combat inflation without

external constraints. For instance, in 2022, amid rising inflation, the BoE raised interest rates promptly to curb inflation, a response that would have been limited under a fixed exchange rate system. This capacity to swiftly adapt to economic conditions highlights the benefits of a floating exchange rate in enhancing the UK's ability to manage financial challenges independently.

In a floating exchange rate system, currency value is determined by market forces, allowing for automatic adjustments. A trade deficit typically results in currency depreciation, which makes exports more competitive and imports more expensive. This self-correcting mechanism reduces trade imbalances without direct government intervention. For example, when the UK imports more than it exports, demand for foreign currencies rises, causing the pound to weaken. This depreciation makes UK goods cheaper for foreign buyers, boosting exports, while making imports more costly and reducing foreign purchases. Such dynamics help maintain economic equilibrium.

During economic downturns, a depreciating currency can stimulate growth by enhancing export competitiveness. In contrast, currency appreciation during inflationary periods can lower import costs, helping stabilize prices. This flexibility makes floating exchange rates essential for adapting to changing economic conditions. A notable example of exchange rate flexibility occurred on 16 September 1992, during Black Wednesday, when the UK exited the European Exchange Rate Mechanism (ERM) due to market pressures. The pound's subsequent depreciation improved export competitiveness and contributed to economic recovery (Barry Eichengreen, 2022).

Under a floating exchange rate system, the UK reduces its reliance on substantial foreign exchange reserves. Since the value of the British pound is determined by market forces, there is no need for active government or central bank intervention to maintain a fixed exchange rate. Prior to adopting a floating exchange rate in 1972, the UK operated under fixed exchange rate regimes, such as the Bretton Woods system, which required significant foreign currency reserves to defend

the pound's fixed value. This often led to economic challenges, including devaluations in 1949 and 1967 to address balance of payments issues.

The transition to a floating exchange rate enabled the pound's value to adjust according to market dynamics, reducing the need for large-scale interventions and extensive foreign exchange reserves. Without the obligation to stockpile foreign currency, the government can allocate resources more effectively, directing funds that would have been used to accumulate reserves toward infrastructure, healthcare, education, and social welfare, promoting long-term economic growth. A recent example of this is the announcement of a £20 billion increase in investment through increased borrowing (Financial Times, 2024). Moreover, large foreign exchange reserves often involve low-yield investments, such as U.S. Treasury bonds. By minimizing the need for excessive reserves, the UK can invest in higher-return assets, enhancing resource allocation efficiency.

A floating exchange rate acts as a buffer against external economic shocks. For example, if the UK experiences a sudden decline in global demand for its exports, the pound can depreciate, making UK goods and services more competitive internationally. This depreciation helps boost exports, mitigating the negative impact on the economy. Similarly, during a global financial crisis, a weaker pound can attract foreign investment, stabilizing capital flows. During the 2008 Global Financial Crisis, the UK's floating exchange rate system played a key role in absorbing the economic shock. As investor confidence plummeted and global demand fell, the pound depreciated sharply from around \$2 per GBP in early 2008 to approximately \$1.40 per GBP by early 2009 (Choudhry, 2015). This depreciation improved the competitiveness of UK exports, as British goods and services became cheaper for foreign buyers, providing critical support to the economy.

Additionally, the weaker pound benefited the UK's tourism sector by making travel to the UK more affordable, further stimulating economic activity.

Monetary policy autonomy is another significant advantage of a floating exchange rate system, enabling the UK to tailor its policies to domestic economic conditions without the need to maintain a fixed exchange rate. This flexibility is especially valuable during economic crises or inflationary pressures. Since the British pound (GBP) is not pegged to any other currency, the BoE can independently adjust interest rates and implement quantitative easing or tightening as required. A clear example occurred during the COVID-19 pandemic (2020-2021), when the UK faced a severe economic downturn due to lockdowns and reduced consumer demand. In response, the BoE lowered interest rates to a historic 0.1% and launched an £895 billion quantitative easing program to inject liquidity and support businesses (UK Parliament, 2021). Under a fixed exchange rate regime, the UK would have been constrained in adjusting interest rates or expanding monetary policy, potentially worsening the economic downturn, as seen in countries that struggled to balance monetary stimulus with exchange rate stability. Moreover, monetary policy autonomy enables the UK to address inflation without external constraints. For example, in 2022, the BoE rapidly raised interest rates to combat rising inflation, a move that could have been limited under a fixed system. This flexibility highlights the advantages of a floating exchange rate, reinforcing the UK's ability to navigate financial challenges independently.

The floating exchange rate system exposes the UK to frequent currency fluctuations driven by political events, economic reports, and global financial instability. For example, Brexit in 2016 led to significant depreciation of the pound due to uncertainty surrounding trade agreements and economic forecasts. Similarly, economic indicators such as inflation data, GDP growth rates, and employment figures can trigger immediate currency shifts (Stoupos, 2021). Market speculation

also contributes to exchange rate volatility, as investors respond to economic and geopolitical developments.

A disadvantage of a floating exchange rate is imported inflation. The UK's reliance on imports for essential goods, such as energy and food, means that a weaker pound raises their costs, exacerbating inflation. For instance, during the 2022 UK energy crisis, the pound's depreciation increased oil and gas prices, which are priced in US dollars, further fueling inflation (Ahmed, 2023). Additionally, a floating exchange rate can impact debt servicing for countries with foreign currency-denominated debt. A depreciating pound increases the cost of repaying foreign debt, straining public finances and businesses with external obligations. In 2022, the UK government's mini-budget led to a sharp decline in the pound, raising borrowing costs (Aldrick, 2022). Exchange rate volatility also introduces economic uncertainty, as seen after the 2016 Brexit vote, when the pound's depreciation hindered business planning, raised inflation, and deterred foreign investment. Countries with managed exchange rate systems, like China, mitigate such instability through intervention, highlighting a drawback of relying solely on market-driven currency valuation.

Prudent fiscal policies are crucial for maintaining investor confidence in the UK economy and stabilizing the exchange rate under a floating exchange rate system, where the British pound (GBP) value is determined by market forces. Excessive government borrowing can lead to inflation, increased debt servicing costs, and capital flight, all of which contribute to currency depreciation. Responsible fiscal management reassures investors, thereby increasing demand for UK assets such as government bonds, which supports the pound's value. In contrast, excessive borrowing without a clear repayment strategy can erode investor confidence, triggering capital outflows and currency instability.

Controlling inflation is paramount, as elevated budget deficits often necessitate borrowing or monetary expansion, thereby inducing inflationary pressures, depreciating the pound, and diminishing export competitiveness. External debt management necessitates careful consideration of exchange rate risks, which amplify debt servicing costs during currency depreciation. For instance, the UK's response to the 2008 Global Financial Crisis involved austerity measures, including expenditure reductions and tax augmentations, to curtail deficits and bolster market confidence (Farnsworth, 2011). These actions stabilized public debt and investor confidence, maintaining relative currency stability amidst global uncertainty. To reinforce fiscal discipline, policymakers should establish debt-to-GDP ratio targets (e.g., <80%), prioritize resource allocation to productive sectors (infrastructure, education), and implement revenue-enhancing tax reforms. Furthermore, the accumulation of foreign exchange reserves for contingency funds can mitigate currency volatility, while aligning fiscal policy with monetary objectives prevents policy conflicts that destabilize exchange rates.

Expanding trade relationships and diversifying investments are crucial for mitigating the impact of exchange rate fluctuations on the UK economy. A trade portfolio concentrated in a few markets exposes the UK to vulnerabilities from currency volatility, geopolitical tensions, and economic downturns. By diversifying trade partnerships, including with emerging markets, the UK can reduce reliance on any single country or trading bloc. Post-Brexit trade policies have driven the UK to secure agreements with countries like Australia and India to decrease dependence on the EU (Garcia, 2023). The 2023 UK-Australia Free Trade Agreement eliminates tariffs on most goods and opens new investment opportunities, reducing dependency on European markets. Additionally, promoting domestic production in sectors such as energy, pharmaceuticals, and agriculture can mitigate imported inflation. A weaker pound raises the cost of imports, driving up



consumer prices. The UK's investment in offshore wind energy, for example, aims to reduce reliance on imported fossil fuels, insulating the economy from exchange rate-driven energy price fluctuations. Attracting foreign direct investment (FDI) from diverse global sources enhances economic stability by reducing the risk of capital flight during periods of currency depreciation. The UK's efforts to attract tech sector investments, such as Microsoft's £2.5 billion investment in AI and cloud infrastructure in 2023, help balance economic reliance beyond Europe (HM Treasury, 2023). Through trade expansion, domestic production, and investment diversification, the UK can strengthen its resilience to exchange rate uncertainties.

Despite the UK's floating exchange rate regime, the government and the BoE must monitor exchange rate dynamics to mitigate excessive volatility. While direct intervention is typically eschewed, strategic market operations during crises can restore confidence. For instance, the BoE's 2008 crisis liquidity measures and coordinated central bank actions indirectly supported exchange rate stability (Farnsworth, 2011). Similarly, in 2022, the BoE's government bond purchases countered the pound's depreciation following unfunded tax cut announcements. These interventions underscore the importance of investor confidence via calibrated policy. Utilizing forward guidance, reserve management, and temporary interventions, the UK can temper fluctuations within a floating exchange rate framework. Monitoring also enables preemptive risk mitigation against speculative attacks or geopolitical disruptions, ensuring stability.

Enhancing economic fundamentals is also crucial for maintaining the UK's global competitiveness and stabilizing the pound (Bambi, 2021). Policies that boost productivity, foster innovation, and attract investment help draw foreign capital, reducing the risks of currency depreciation. A resilient economy builds investor confidence, increasing demand for British assets and stabilizing the exchange rate. For example, the UK government has prioritized investments in

high-tech industries, renewable energy, and financial services to promote growth. The expansion of the UK's technology sector, particularly in fintech and artificial intelligence, has positioned London as a global innovation hub, attracting billions in foreign direct investment (FDI). In 2023, the UK secured over £30 billion in tech investments, strengthening the pound through increased foreign demand. Additionally, investments in renewable energy, such as offshore wind, have improved energy security and reduced reliance on imported fossil fuels, mitigating the impact of currency depreciation on energy costs. By focusing on policies that enhance workforce skills, infrastructure, and research and development (R&D), the UK can ensure long-term economic stability. A diversified, innovation-driven economy provides a strong foundation for exchange rate resilience, shielding the pound from external shocks and speculative pressures.

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