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October 12, 1990

To: Members of the Executive Board
From: The Secretary
Subject: United Kingdom - Exchange Arrangement

Attached for the information of the Executive Directors is a paper on a recent change in the exchange system of the United Kingdom.

Mr. Bercuson (ext. 8795) is available to answer technical or factual questions relating to this paper.

Att: (1)

Other Distribution:
Department Heads

INTERNATIONAL MONETARY FUND

UNITED KINGDOM - EXCHANGE ARRANGEMENT

Prepared by the European Department

(In consultation with the Exchange and Trade Relations
and Legal Departments)

Approved by Massimo Russo

October 12, 1990

In their communication to the Secretary dated October 10, 1990 (EBD/90/326), the United Kingdom authorities informed the Fund that effective October 8, 1990, the United Kingdom had joined the exchange rate mechanism (ERM) of the European Monetary System (EMS) 1/ with a central exchange rate at DM 2.95. The authorities also announced that, in accordance with the transitional provisions of the EMS agreement, they would initially maintain margins of 6 percent above or below the central rates for the other ERM member currencies 2/. As do other members of the ERM, the Bank of England would stand ready to buy or sell currencies in unlimited amounts at the specified intervention rates. Table 1 presents the central rate and the intervention limits for the pound sterling together with the central rates and intervention limits for the other members of the ERM. These latter limits between the currencies of countries that were already in the ERM were not changed by the entry of the United Kingdom.

Prior to the change effected on October 8, 1990, the pound sterling was an independently floating currency. It had, however, been the long-standing intention of the U.K. authorities to participate in the ERM once appropriate conditions had presented themselves. The main reason for delaying entry had been the wide inflation differential between the United Kingdom and those countries already participating in the ERM. By August 1990, the 12-month rate of increase in the U.K. retail price index had reached 10.6 percent. Over the same period, retail price inflation excluding interest rate increases and changes in local taxes--that might be regarded as more representative of the underlying rate of inflation--reached 7.9 percent, which was over 3 percentage points above the corresponding average of other ERM members.

1/ The participants of the ERM now include Belgium, Denmark, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Spain, and the United Kingdom.

2/ At present, a 6 percent margin is also maintained by Spain, while the other members of the ERM maintain margins of 2 ½ percent around their central rates.

Table 1. EMS: Bilateral Central Rates
and Intervention Limits

(Effective October 8, 1990)

		100 Belgian/Lux. francs	100 Danish kroner	100 French francs	100 German deutsche marks	1 Irish pound	1,000 Italian lire	100 Netherlands guilders	100 Spanish pesetas	1 pound sterling
Belgian/Luxembourg										
franc	L	...	553.000	628.970	2109.50	56.5115	28.1930	1872.15	33.6930	64.6050
	C	...	540.723	614.977	2062.55	55.2545	27.5661	1830.54	31.7316	60.8451
	U	...	528.700	601.295	2016.55	54.0250	26.9530	1789.85	29.8850	57.3035
Danish krone										
	L	18.9143	...	116.320	390.160	10.4511	5.21400	346.240	6.23100	11.9479
	C	18.4938	...	113.732	381.443	10.2186	5.09803	338.537	5.86837	11.2526
	U	18.0831	...	111.200	373.000	9.9913	4.98500	331.020	5.52600	10.5976
French franc										
	L	16.6310	89.9250	...	343.050	9.18900	4.58450	304.440	5.47850	10.50550
	C	16.2608	87.9257	...	335.386	8.98480	4.48247	297.661	5.15981	9.89389
	U	15.8990	85.9700	...	327.920	8.78500	4.38300	291.040	4.85950	9.31800
German mark										
	L	4.95900	26.8100	30.4850	...	2.74000	1.36700	90.7700	1.63300	3.13200
	C	4.84837	26.2162	28.8164	...	2.67894	1.33651	88.7526	1.53847	2.95000
	U	4.74000	25.6300	29.1500	...	2.61900	1.30650	86.7800	1.44900	2.77800
Irish pound										
	L	1.85100	10.00870	11.3830	38.1825	...	0.510246	33.8868	0.609772	1.16920
	C	1.80981	9.78604	11.1299	37.3281	...	0.498895	33.1293	0.574281	1.10118
	U	1.76950	9.56830	10.8825	36.4964	...	0.487799	32.3939	0.540858	1.03710
Italian lira										
	L	3710.20	20062.0	22817.0	76540.0	2050.03	...	67912.0	1222.30	2343.62
	C	3627.64	19615.4	22309.1	74821.7	2004.43	...	66405.3	1151.11	2207.25
	U	3546.90	19179.0	21813.0	73257.0	1959.84	...	64928.0	1084.10	2078.79
Netherlands										
guilder	L	5.58700	30.2100	34.3600	115.2350	3.08700	1.54000	...	1.84050	3.52950
	C	5.46286	29.5389	33.5953	112.6730	3.01848	1.50590	...	1.73345	3.32389
	U	5.34150	28.8825	32.8475	110.1675	2.95100	1.47250	...	1.63250	3.13050

Table 1 (concluded). EMS: Bilateral Central Rates
and Intervention Limits

(Effective October 8, 1990)

		100 Belgian/Lux. francs	100 Danish kroner	100 French francs	100 German deutsche marks	1 Irish pound	1,000 Italian lire	100 Netherlands guilders	100 Spanish pesetas	1 pound sterling
Spanish peseta	L	334.619	1809.40	2057.80	6901.70	184.892	92.2400	6125.30	...	203.600
	C	315.143	1704.05	1938.06	6500.00	174.131	86.8726	5768.83	...	191.750
	U	296.802	1604.90	1825.30	6121.70	163.997	81.8200	5433.10	...	180.590
U.K.										
pound sterling	L	1.74510	9.43610	10.7320	35.9970	0.964240	0.481050	31.9450	0.553740	...
	C	1.64352	8.88687	10.1073	33.8984	0.908116	0.453053	30.0853	0.521514	...
	U	1.54790	8.36970	9.5190	31.9280	0.855260	0.426690	28.3340	0.491160	...

Source: EC Commission.

Legend: L = Lower intervention limit; C = Bilateral central rate; and U = Upper intervention limit.

Over the past 18 months, the authorities have sought to reduce inflation by tightening the stance of financial policies. In this connection, the base rate of interest was raised in steps to 15 percent, at which level it was maintained over the past year. In response to this tightening of policies, there has been a marked slowdown in domestic demand and activity. The authorities expect that the prospect is now for a substantial reduction in inflation over the coming year both in absolute terms and in relation to inflation in other European countries. Against the background of the recent weakening in domestic demand and within the context of the new exchange arrangement, the authorities also announced that effective October 8, 1990, the base interest rate would be reduced to 14 percent.

The authorities have reaffirmed their view that a tight monetary policy and a firm exchange rate remain essential to bring inflation down. It was precisely in order to reinforce the existing framework of monetary discipline that they had decided that the United Kingdom should now join the ERM. It was anticipated that the discipline imposed by participation in the ERM would act to restrain wages as companies would find it difficult to pass along higher wage costs in the form of higher output prices. It was also thought that membership in the ERM would make the process of reducing inflation less painful as the credibility of policies would be enhanced.

Over the past six months, the pound sterling appreciated by approximately 10 percent in relation to both the deutsche mark and the ECU apparently in anticipation of ERM entry and in response to developments in international oil prices (Charts 1 and 2). In the immediate aftermath of entry into the ERM, the pound sterling rose to around DM 3.00 on October 9, 1990 or to almost 2 percent above its central rate. The trade weighted real effective exchange rate of the pound sterling, based on relative consumer prices, stood at 109.9 in August 1990 as compared to an average level of 100.0 in 1985 (Chart 3).

The 1990 Article IV consultation mission is scheduled to visit the United Kingdom in December 1990. On that occasion, the staff will discuss exchange rate policy with the authorities and provide the Executive Board with an appraisal of the recent change in the United Kingdom's exchange rate system.

CHART 1
UNITED KINGDOM
STERLING DEUTSCH MARK EXCHANGE RATE

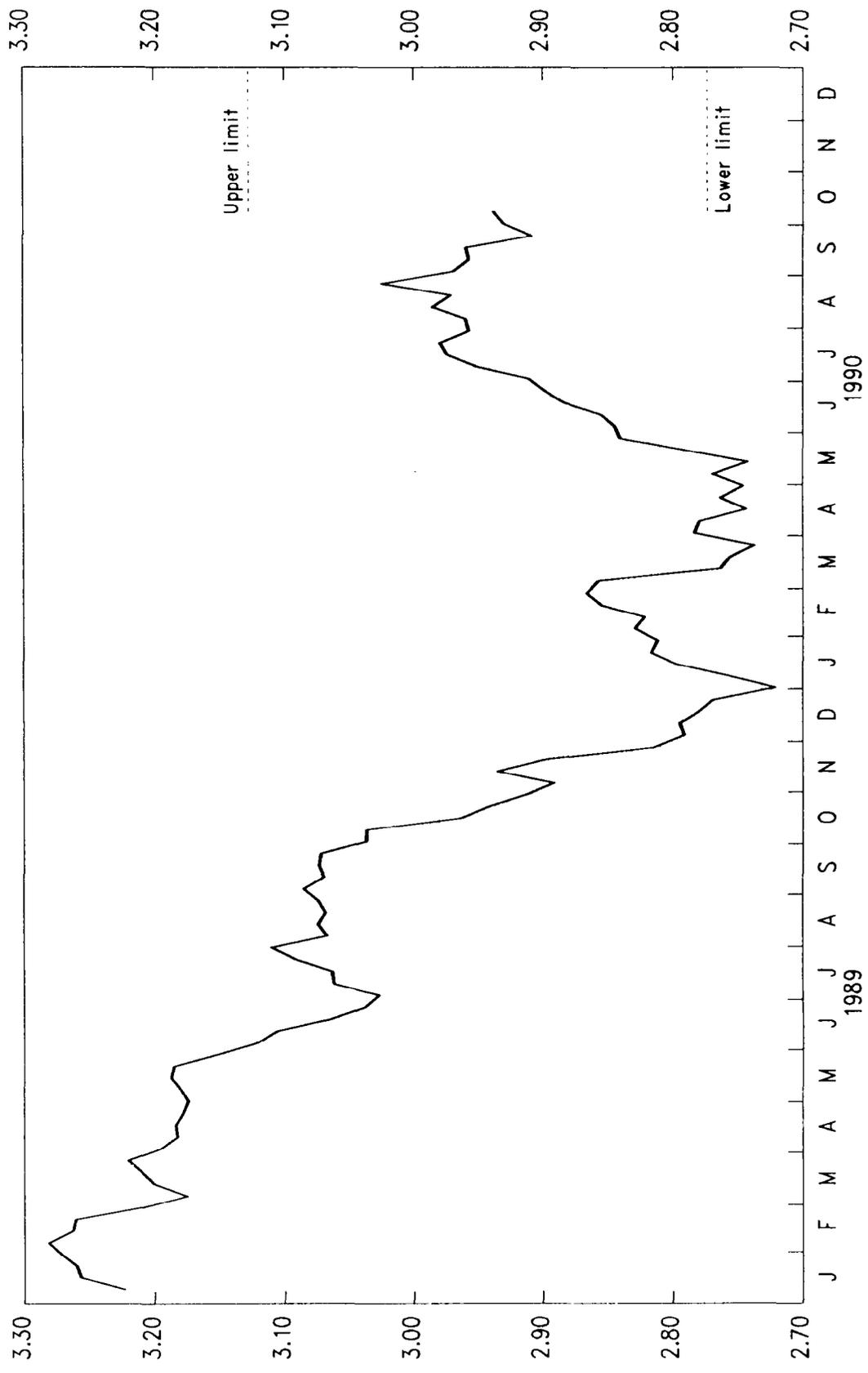


CHART 2
UNITED KINGDOM
STERLING ECU EXCHANGE RATE

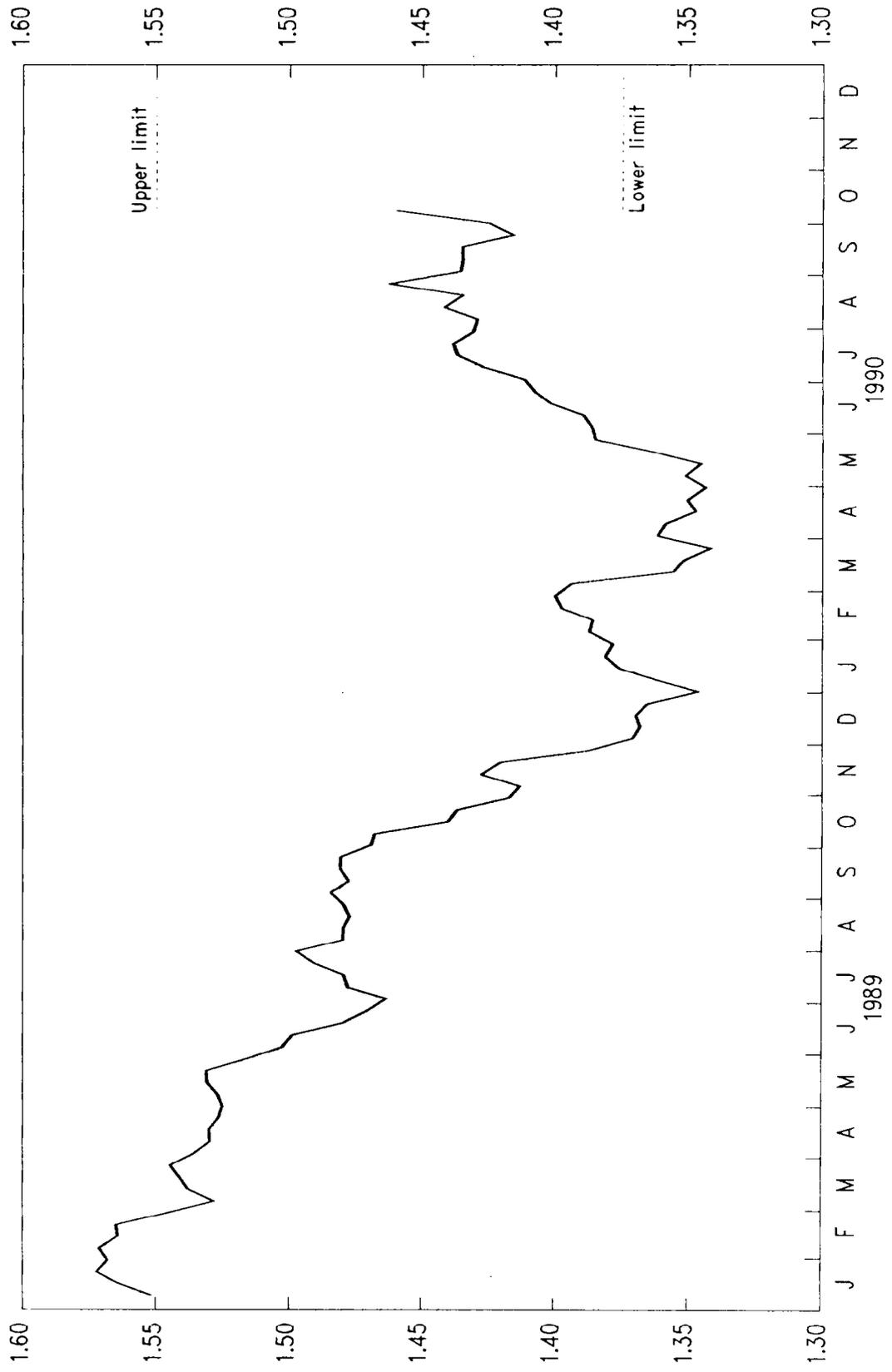
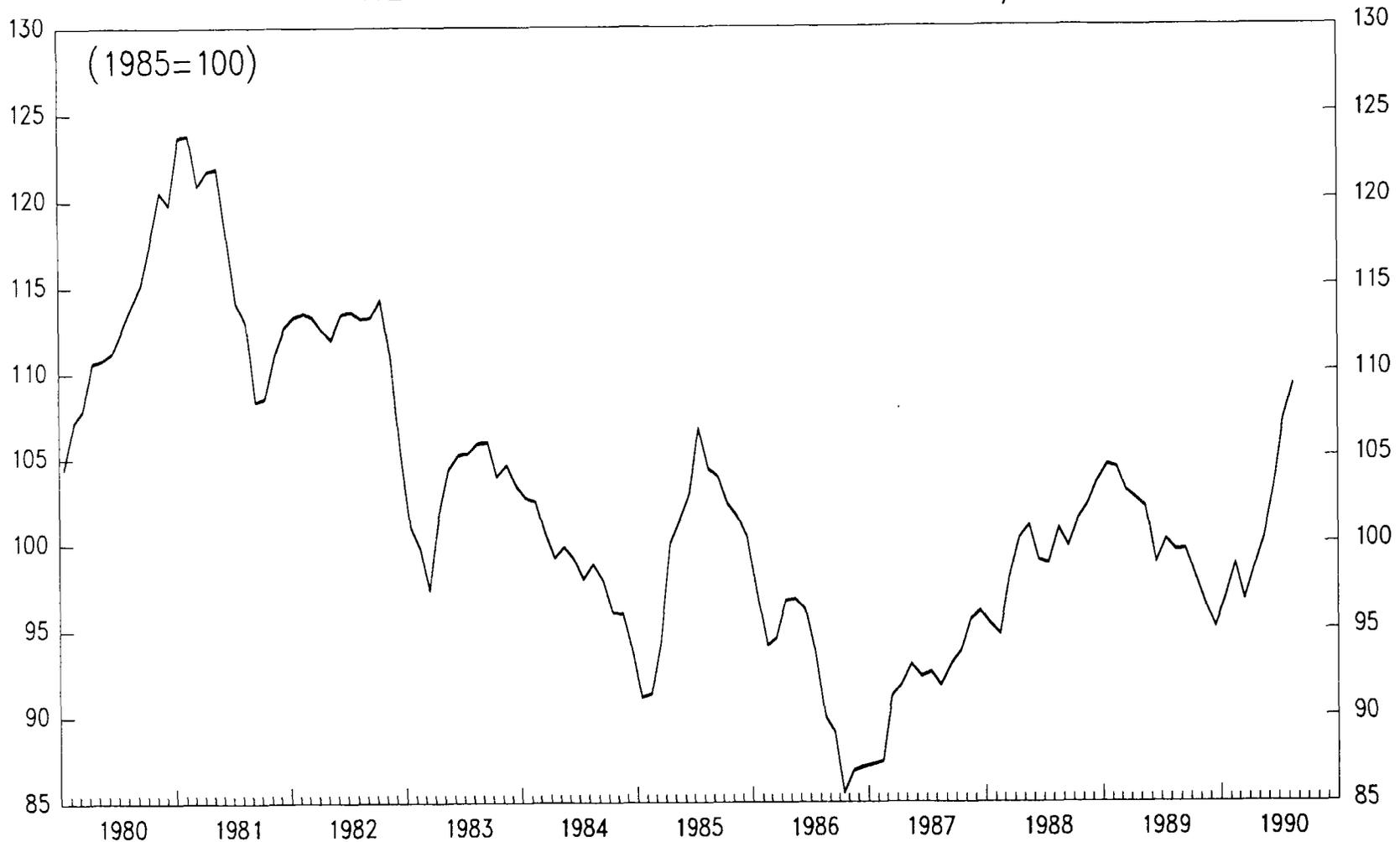


CHART 3
UNITED KINGDOM
REAL EFFECTIVE EXCHANGE RATE 1/



Source: IMF, International Financial Statistics.

1/ Based on relative consumer prices.

