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CONTAINS CONFIDENTIAL INFORMATION

February 21, 1986

To: Members of the Executive Board

From: The Acting Secretary

Subject: United Kingdom - Staff Report for the 1985 Article IV Consultation

The attached supplement to the staff report for the 1985 Article IV consultation with the United Kingdom has been prepared on the basis of additional information.

Mr. Horiguchi (ext. 8795) or Ms. Salop (ext. 8793) is available to answer technical or factual questions relating to this paper prior to the Board discussion on Monday, February 24, 1986.

Att: (1)

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INTERNATIONAL MONETARY FUND

UNITED KINGDOM

Staff Report for the 1985 Article IV Consultation
Supplementary Information

Prepared by the European Department

Approved by Brian Rose

February 21, 1986

According to the latest data, financial developments in the U.K. economy in the most recent period deviated somewhat from the trends discussed in the staff report. Bank lending, for example, rose by only £0.4 billion in January, compared with a monthly average of £1.7 billion over the previous 6 months, and the growth in £M3 was down slightly to 14.0 percent over the previous 12 months and more significantly to 11.1 percent (annual rate) over the previous 3 months. Also in a break from the trend observed in 1985, the growth in Mo accelerated in January, to 4.5 percent over the previous 12 months and 9.8 percent (annual rate) over the previous 3 months. This largely reflects what appears to be a temporary bulge in bankers' operational balances at the Bank of England.

Banks' base lending rates have remained at 12 1/2 percent since January 8 when, in the face of strong downward pressure on sterling and concerns about the buoyancy of bank lending, the authorities endorsed a 1 percentage point rise. In the following week, however, the Bank of England is reported to have resisted a further rise in base rates on the grounds that pressure on sterling was clearly due to oil market developments and that monetary conditions were sufficiently tight to forestall a resurgence of inflationary pressure.

The PSBR for January was better than expected, reflecting a strong increase in non-oil tax revenues. The cumulative PSBR for the first 10 months of the 1985/86 financial year totaled £3.2 billion, compared with £7.8 billion in the first 10 months of 1984/85. Although monthly figures for the PSBR, which are not seasonally adjusted, fluctuate widely, it now appears possible that the PSBR for 1985/86 might turn out below the £8 billion forecast in the Autumn Statement. The recent large fall in oil prices is not likely to be felt significantly until 1986/87.

In other domestic developments, the rate of inflation in the RPI continued to decline in January to 5.5 percent, while the increase in producer prices rose slightly to 5.2 percent. The price index for materials and fuels purchased by manufacturing fell by 7.1 percent in the 12 months through January; it had fallen by 6 percent in the 12 months through December. Adult unemployment jumped in January after a 6-month period of virtual stability; the seasonally adjusted unemployment rate now stands at 13.2 percent, where it had been during much of last summer. Retail sales were lower than generally expected in January, registering a decline of 1.1 percent on a seasonally adjusted basis; even so, they were 2.3 percent above their level 12 months previously.

On preliminary data, the current account of the balance of payments recorded a surplus of £1.4 billion in the fourth quarter of 1985, bringing the surplus for the year as a whole to £3.5 billion (about 1 percent of GDP). Visible trade was broadly in balance, compared with a deficit of £0.5 billion in the third quarter, as there was a sharp drop in the non-oil trade deficit as a result of a large improvement in the terms of trade. The invisibles surplus is estimated at £1.4 billion, down £0.3 billion from the third quarter.

Sterling depreciated by 9 percent in nominal effective terms between early December and midday on February 21. The depreciation was 4 1/2 percent against the U.S. dollar and 11 1/2 percent against other currencies on average (see attached table). Over the same period the price for Brent crude oil for spring delivery fell by about 45 percent.

While there may be important sectoral effects from the large decline in oil prices, on balance the effect on the U.K. economy is apt to be small. To be sure, there will be a deterioration in the terms of trade which, given net oil exports of £8 1/2 billion, is estimated to amount to about 1 percent of GDP. However, the effect of the deterioration in the terms of trade will largely fall on government revenues and profits in the energy sector. Overall, the personal sector should gain, although the extent of the gain depends on decisions taken by the authorities with respect to the exchange rate and the budget. As noted on page 12 of the staff report, a 10 percent drop in oil prices in terms of U.S. dollars and a 3 percent depreciation in the effective exchange rate of sterling would tend to have broadly offsetting effects on inflation; sterling's depreciation relative to the decline in oil prices since early December has been somewhat smaller. A continuation of this trend would tend to stimulate consumption, while leaving wage demands little affected by the depreciation of the nominal exchange rate. The attendant reduction in the real exchange rate would also have stimulatory effects, with the resulting improvement in the non-oil trade balance in time offsetting the weakening in the oil trade balance. This process would be speeded by the likely expansionary effect of the oil price drop on the United Kingdom's trading partners.

United Kingdom: Sterling Exchange Rate Indices

(January 1984 = 100; monthly averages except as indicated)

		US$/£	Nominal Effective Exchange Rate (MERM)	MERM Excluding US$
1984	January	100.0	100.0	100.0
	February	102.2	100.4	100.2
	March	103.4	98.8	97.3
	April	101.0	97.4	96.2
	May	98.6	97.6	97.3
	June	97.8	97.0	95.6
	July	93.7	95.5	96.1
	August	93.3	95.8	96.6
	September	89.4	94.3	95.9
	October	86.6	92.1	93.9
	November	88.2	92.4	93.8
	December	84.3	90.4	92.4
1985	January	80.2	87.3	89.8
	February	77.8	87.2	90.4
	March	79.7	89.5	93.1
	April	88.2	95.2	97.6
	May	88.7	96.2	98.8
	June	90.9	97.6	99.9
	July	97.8	101.7	103.0
	August	98.4	99.8	100.2
	September	96.9	99.2	100.0
	October	101.0	98.1	97.2
	November	102.2	97.7	96.2
	December	102.7	96.7	94.7
1986	January	101.5	93.8	91.2
Memoranda items:				
1985	September 20 1/	97.1	100.0	101.0
	December 6 2/	104.9	99.0	97.1
1986	February 21 3/	102.5	90.9	87.1

Source: Staff calculations based on IMF Data Fund and data from the Bank of England.

1/ Prior to Plaza Agreement on September 22, 1985.
2/ Prior to OPEC meeting on December 9-10, 1985.
3/ Midday.