EBS/85/203

CONFIDENTIAL

August 26, 1985

To: Members of the Executive Board

From: The Acting Secretary

Subject: United Kingdom - Real Effective Exchange Rate - Information Notice

There is attached for the information of the Executive Directors an information notice on the real effective exchange rate of the pound sterling.

Mr. Belanger (ext. 8671) is available to answer technical or factual questions relating to this paper.

Att: (1)

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INTERNATIONAL MONETARY FUND

UNITED KINGDOM

Real Effective Exchange Rate--Information Notice

Prepared by the European Department and
the Exchange and Trade Relations Department

(In consultation with the Legal Department and
the Research Department)

Approved by C. David Finch and P. de Fontenay

August 23, 1985

The recent evolution of the real effective exchange rate of the pound sterling, as measured by the standard index developed in connection with the information notice system, is set out in the attached table and chart. Based on this index, the pound sterling is estimated to have appreciated in real effective terms by 13.5 percent from March 1985 (the month in which the Executive Directors last discussed the United Kingdom's exchange rate policy) to July. 1/ Of the 13.5 percent real appreciation, 12.8 percentage points are accounted for by an appreciation in nominal terms. In July, the real effective value of sterling stood at a level some 23 percent above its average for the period 1974-84, though about 7 1/2 percent below its peak level in the first quarter of 1981.

Part of the strengthening of the pound sterling from March to July reflected the general weakening of the U.S. dollar, but sterling also posted substantial gains against other currencies. The main force underpinning the appreciation of sterling seems to have been the relatively high level of short-term interest rates in the United Kingdom. These rates were raised by 4 1/2 percentage points (to 14 percent) in January of this year in response to a perceived easing of monetary conditions. There has been a partial reversal of this rise, but U.K. short-term rates still stand at around 11 1/2 percent, some 2 percentage points above the early January levels. (Recent interest rate developments are shown in Chart 2.)

1/ On March 6, 1985, the Executive Board discussed the staff report for the 1984 Article IV consultation (SM/85/44, 2/6/85) and the information notice (SM/85/44, Sup. 1, 3/5/85), in which Directors' attention was drawn to the real depreciation of sterling from February 1984 to January 1985, which was estimated to have amounted to 10.4 percent. With the latest revisions to the normalized unit labor cost data in July, it is now estimated that the depreciation during that period amounted to 8.6 percent.

The differential between three-month sterling interbank rates and Eurodollar rates widened from less than 1 1/2 percentage points at the beginning of January to some 4 1/2 percentage points at the end of the month; it remained at about that level through the first half of July before narrowing by approximately 1 percentage point in the second half of the month. Differentials vis-à-vis interest rates on Eurodeposits denominated in other major currencies followed broadly similar paths. Other factors contributing to the strengthening of sterling may have been the termination in March of the protracted coal miners' strike and the fairly rapid expansion of output during the three most recent quarters.

Other developments have been less favorable to the recovery of sterling. For example, the increasing evidence of softness in world oil markets is likely to have limited the size of the appreciation. Also, £M3, the targeted broad monetary aggregate, has been growing rapidly. Over the 12 months through the banking month of July, 1/ £M3 rose by 12 percent, compared with the target range of 5-9 percent. This rapid growth may be explained in part by the deregulation of the banking system and the increased competition between banks and building societies. The main counterpart of the rapid growth of £M3 has been the strong increase in bank lending to the private sector, particularly to the company sector. This is thought to reflect, to some extent, phased changes in capital allowances announced in the last year's budget that encourage the bringing forward of business fixed investment. In contrast to £M3, the targeted narrow aggregate, monetary base or Mo, has grown at a rather moderate pace. Over the 12 months through banking July, it rose by 5 percent, compared with the target range of 3-7 percent.

On the fiscal side, the 1985/86 budget announced in March envisaged that the PSBR in financial year 1985/86 would total £7 billion (2 percent of GDP), compared with £10 1/2 billion the year before. There have been some adverse developments since the presentation of the budget. The authorities nevertheless remain confident that the PSBR target for 1985/86 is attainable, barring a further significant drop in oil prices in sterling terms. Oil revenue seems likely to fall short of the budgeted level by about £2 billion, owing largely to the appreciation of sterling, but this shortfall is expected to be broadly offset by an increase in other revenues resulting from the higher-than-expected increase in nominal income. There have been slippages on the expenditure side also, including overruns on public sector pay; these are still expected to be met out of the contingency reserve.

After fluctuating narrowly around 5 percent throughout most of 1984, the 12-month rate of increase in the retail price index (RPI) rose steadily in the first half of 1985, reaching 7.0 percent in June; it declined to 6.9 percent in July under the influence of a fall in seasonal food and gasoline prices. The acceleration of the RPI in the first half of this year was due primarily to the lagged effects of the large depreciation of sterling in 1984 and to the rise in mortgage rates that followed

1/ The four weeks ended July 17.

the sharp increase in market interest rates in January. The direct inflationary impulse from these sources is expected to taper off beginning in late summer, reflecting the recovery of sterling since February and the bulge in mortgage rates a year earlier. Sterling's rebound has already resulted in a marked deceleration in producer input prices in the past few months. In June, the index of manufacturers' input prices actually fell by 1.1 percent, bringing the 12-month rate of increase down to 2.2 percent in that month, compared with 3.2 percent in May and 9 percent in January.

The process of wage disinflation continues to be very slow in the United Kingdom. Over the past year, the underlying increase in average earnings (measured over 12 months) has changed relatively little despite high and rising unemployment which reached 13.1 percent of the labor force in the second quarter of 1985. Indeed, there are indications that in manufacturing the underlying increase in average earnings has begun to reaccelerate from the low of 8 1/2 percent. Reflecting the continued momentum of nominal wage increases and a progressive slowing in productivity growth, labor cost pressures in U.K. manufacturing have been intensifying. The 12-month rate of increase in unit wage costs in manufacturing averaged 7.8 percent in the first five months of 1985, compared with 2.2 percent in the first half of 1984, and was significantly higher than the average in competitor countries.

On the external side, the current account is generally expected to strengthen in 1985, following a £2 1/2 billion deterioration (to approximate balance) in 1984, a development that is fully explained by the coal miners' strike in 1984 and its termination in March 1985. Preliminary estimates indicate that the current account registered a surplus of about £1 1/4 billion in the first half of this year, after having recorded a small deficit in the second half of 1984. The improvement was concentrated in the second quarter, when an exceptionally large oil trade surplus and a marked reduction in the non-oil trade deficit (due in large part to a sizable decline in the volume of imports) combined to bring the deficit in the overall visible trade account to its lowest level since early 1983. It does not appear likely that the strengthening of visible trade would continue for long, given the large real appreciation of the pound and the recent and prospective weakening of oil prices.

Sterling depreciated by 5 percent in nominal effective terms during the first several days of August, following a 1 percentage point decline in commercial banks' base lending rates in the second half of July. Sterling has recovered somewhat since then, reflecting the renewed weakness of the dollar, but as of August 20 its effective value was still some 3 percentage points below the level prevailing at the end of July and about 1 1/2 percentage points below the July average.

Staff Appraisal

The strengthening of the pound during the period under review appears to be a reflection mainly of the sharp widening of interest rate differentials in favor of pound-denominated assets following the steps taken in January by the U.K. authorities to tighten domestic monetary conditions. These steps were prompted by a judgment that the steep depreciation of the pound that had occurred was due in part to the market's perception that financial policies had been drifting away from the stringency required to support the Government's anti-inflationary objectives. During the 1984 Article IV consultation with the United Kingdom in March of this year, Executive Directors concluded that those steps had been warranted to provide the basis for the desired wage and price restraint.

The U.K. authorities have repeatedly stated that interest rates will be kept at such levels as are necessary to bring inflation down. The staff continues to support this policy. Price inflation in the United Kingdom has reaccelerated this year--although it is expected to moderate in the coming months--and developments on the wage front remain worrisome. Until there is clear evidence that inflation, particularly of wages, is under control, caution must continue to be exercised in the conduct of monetary policy.

Monetary restraint aimed at a moderation of wage-price pressure typically leads to some temporary appreciation of the currency until the targeted moderation actually takes place. The implied loss of competitiveness comes at an awkward time for the United Kingdom's external accounts, when international oil prices are expected to weaken and North Sea oil production is expected to level off.

United Kingdom: Real Effective Exchange Rate and Related Series 1/

(Indices: 1980 = 100)

	Real Effective Exchange Rate 2/ 3/	Nominal Effective Exchange Rate 2/	Relative Normalized Unit Labor Costs (Local Currencies) 4/	Normalized Unit Labor Costs	Exchange Rate (U.S. dollars per Pound Sterling) 2/
Quarterly					
1980					
I	92.2	96.5	95.6	92.4	96.9
II	97.6	98.4	99.2	98.1	98.2
III	102.1	100.7	101.4	102.8	102.4
IV	108.5	104.8	103.5	106.7	102.6
1981					
I	112.7	107.1	105.3	109.9	99.3
II	107.1	103.2	103.7	110.2	89.5
III	99.7	95.7	104.1	112.6	78.9
IV	99.3	94.6	104.9	115.3	81.0
1982					
I	100.8	96.2	104.8	116.8	79.4
II	101.0	95.3	106.0	119.6	76.5
III	101.6	96.5	105.3	120.1	74.2
IV	99.8	93.9	106.4	122.3	70.9
1983					
I	90.4	84.6	106.8	123.4	65.9
II	96.6	88.5	109.1	126.2	66.9
III	96.5	89.4	108.0	125.0	64.9
IV	96.5	87.8	109.9	128.0	63.2
1984					
I	96.4	86.3	111.8	130.6	61.7
II	95.2	84.2	113.0	131.8	60.0
III	94.6	82.4	114.7	134.0	55.8
IV	91.8	79.5	115.5	135.7	52.3
1985					
I	90.0	76.4	117.8	138.6	47.9
II	98.9	83.2	118.8	140.6	54.1
Monthly					
1985					
March 5/	92.0	77.7	118.4	139.5	48.2
April	97.7	82.3	118.7	140.1	53.4
May	98.8	83.2	118.8	140.6	53.7
June	100.2	84.3	118.8	141.0	55.1
July	104.4	87.7	119.1	141.6	59.2
Percentage change					
Mar. 1985- July 1985	13.5	12.9	0.6	1.5	22.8

Source: Information Notice System.

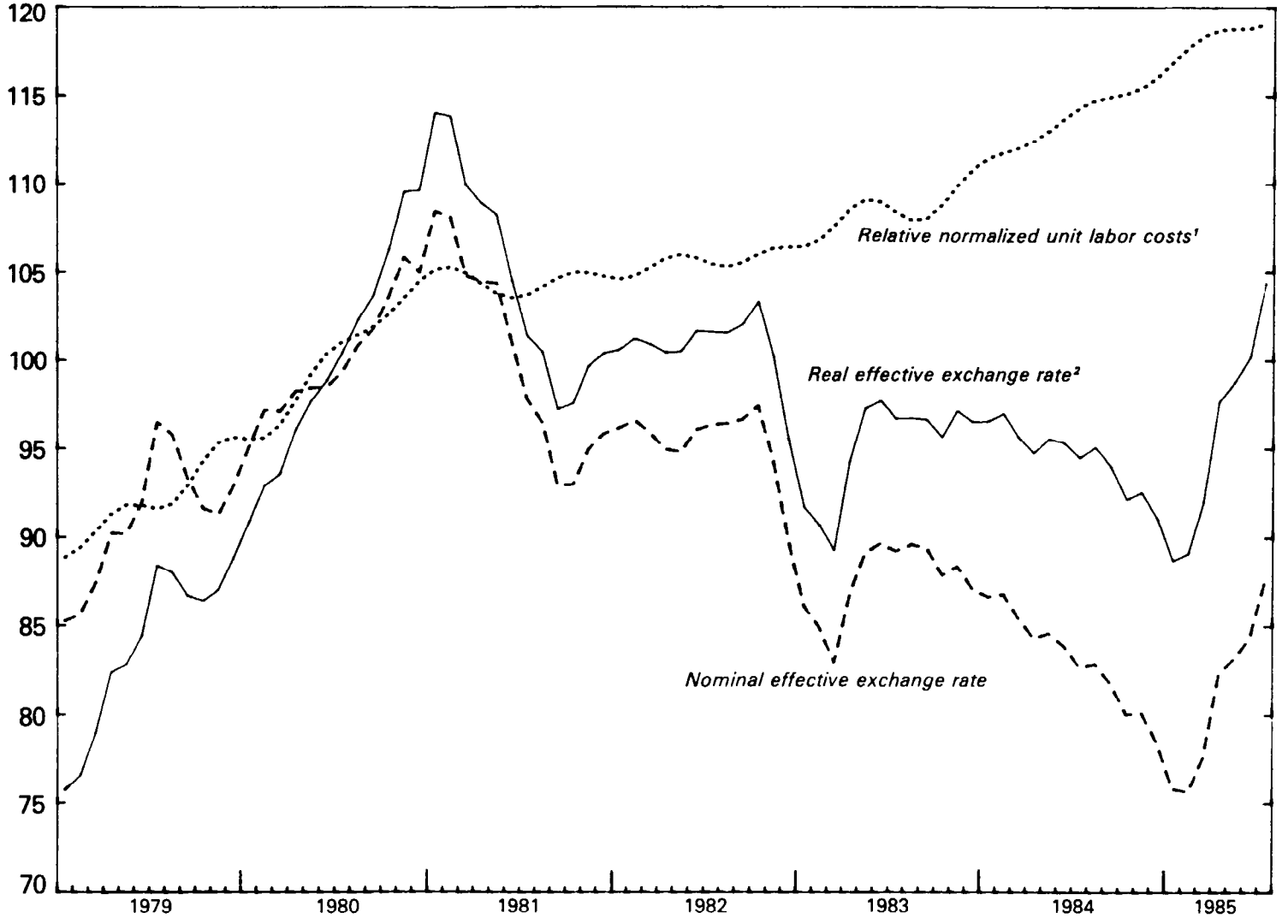
1/ For a description of the weighting scheme used in the Fund's measures of cost and price comparisons for manufacturing, see the notes to that table in International Financial Statistics.
2/ Increases mean appreciation.
3/ Using normalized unit labor costs in local currency terms.
4/ Data for since April 1985 are staff estimates.
5/ Date of latest consideration by Executive Board.

CHART 1

UNITED KINGDOM

INFORMATION NOTICE SYSTEM INDEX OF REAL EFFECTIVE EXCHANGE RATE

(1980 = 100)



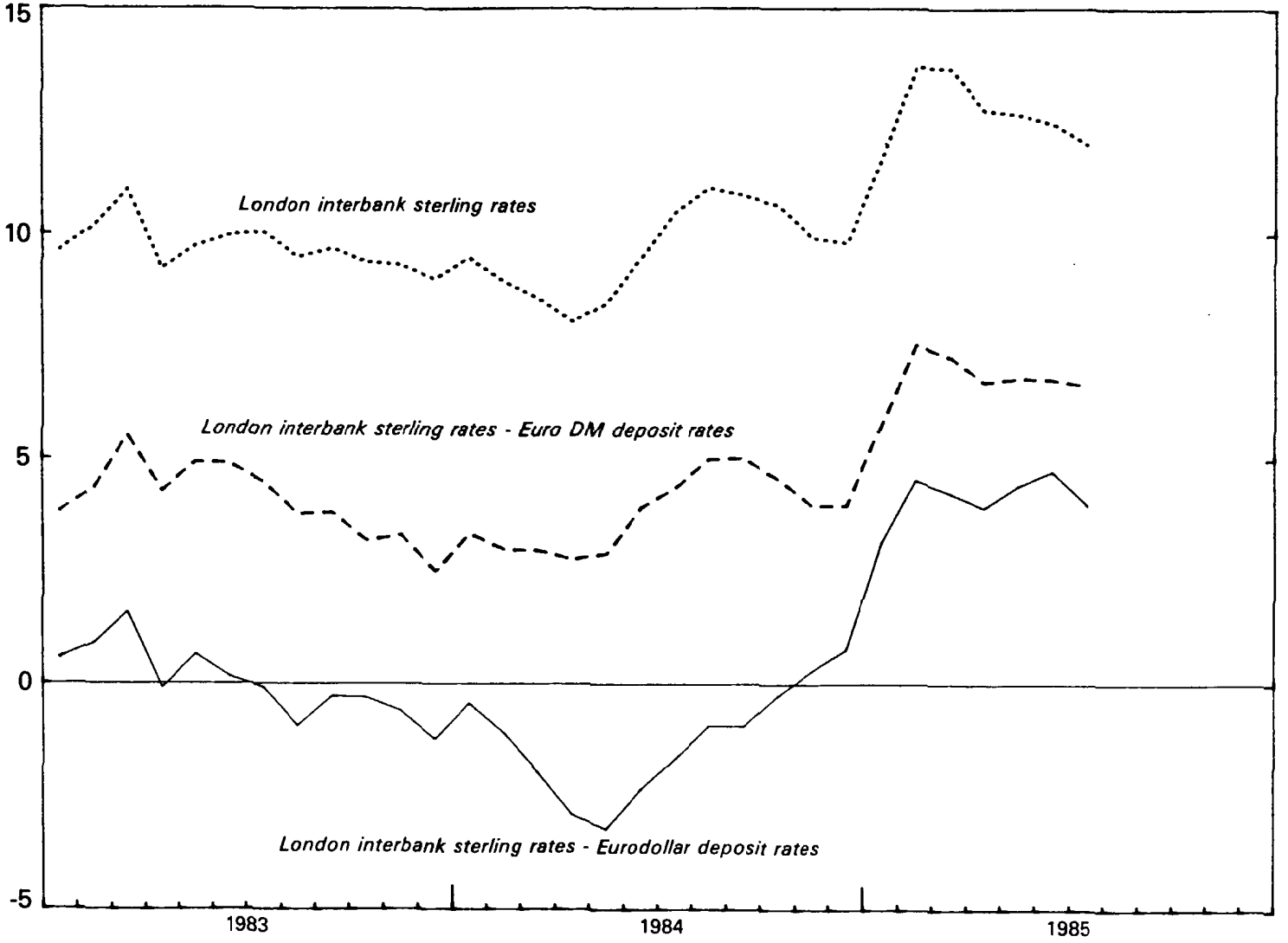
[1] In local currency terms. Data since April 1985 are staff estimates.

[2] Trade weighted index of nominal exchange rates deflated by relative normalized unit labor costs, increases mean appreciation.

CHART 2

UNITED KINGDOM

INTEREST RATE DEVELOPMENTS[1]



Source: IMF, Treasurer's Department.

[1]Based on monthly averages of daily rates on money market instruments with maturity of three months.