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March 5, 1985

To: Members of the Executive Board

From: The Secretary

Subject: United Kingdom - Staff Report for the 1984 Article IV Consultation

The attached supplement to the staff report on the 1984 Article IV consultation with the United Kingdom has been prepared on the basis of additional information.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion on Wednesday, March 6, 1985, they should contact Ms. Salop, ext. 8793.

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INTERNATIONAL MONETARY FUND

UNITED KINGDOM

Staff Report for the 1984 Article IV Consultation Supplementary Information and Information Notice

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

Approved by L. A. Whittome and W. A. Beveridge

March 4, 1985

I. Introduction

Abstracting from the coal miners' strike, output growth appears to have been somewhat stronger in 1984 than in 1983. A special conference of the miners' union (NUM) voted on March 3, 1985 to discontinue the strike; otherwise, labor market trends have continued as before, with employment and unemployment rising together. Financial policies were tightened with the rise in interest rates to 14 percent in January, though the precise effects on the monetary aggregates will be apparent only with the release of the relevant statistics on March 12. The Treasury recently published a Public Spending White Paper, reckoning on a greater overspending in the 1984/85 financial year than was foreseen in the Autumn Statement; to some extent, the effect on the PSBR will be offset by the rise in oil revenues resulting from the depreciation of sterling against the U.S. dollar. Sterling continued to weaken towards the U.S. dollar after the January increases in interest rates; however, half of the depreciation in nominal effective terms from the beginning of the year was reversed in February.

As of January 1985 the pound sterling had depreciated in real effective terms by more than 10 percent since the last occasion on which developments in the United Kingdom's exchange rate were discussed by the Executive Board, i.e., the 1983 Article IV consultation in February 1984. Under the procedures of the information notice system, the depreciation, which is estimated to have amounted to 10.4 percent in terms of normalized unit labor costs, needs to be brought to the attention of the Executive Board.

II. Main Trends

The rate of price inflation rose to 5 percent in January, after declining to 4.6 percent in December. The increase reflected abnormally large price increases for seasonal food items and a rise in rail fares. There may be a further jump in February on the basis of higher food and petrol prices and a rise in mortgage rates. The latest Treasury forecast, published in the Autumn Statement, put inflation at 4.75 percent for the first nine months of 1985, dropping to 4.5 percent in the final quarter.

Real GDP on the output measure grew by 2.5 percent in 1984. It is estimated that without the miners' strike, the growth rate would have been 3.6 percent, that is, the highest rate recorded since 1973. In manufacturing, which was little affected by the strike, output grew by 3.3 percent. Contrary to expectations, this was larger than the growth rate recorded in 1983 and indeed larger than in any year since 1973. Industrial production, which includes the output of the coal industry, rose by only 0.9 percent; without the strike, industrial production might have risen 3.5 percent, or slightly more than in 1983.

With the first anniversary of the strike coming close, coal miners had been returning to work in increasing numbers. By the time of the vote to end the strike, more than 50 percent of the labor force was at work. In other labor market developments, the seasonally adjusted unemployment rate for adults stood at 13.0 percent in January, after hovering around 12.9 percent since September 1984. Registered vacancies declined for the third straight month, although the total for January 1985 was 6.5 percent more than in January 1984. The underlying increase in average earnings continued to run ahead of inflation in the year to December at 6.5 percent and 7.5 percent, respectively, for the whole economy and manufacturing.

On a seasonally adjusted basis, the current account of the balance of payments was in surplus by £0.6 billion in the three months ending January, compared with a deficit of £0.6 billion in the previous three months. The improvement was based on a reduction of the deficit on visible trade, with both the surplus on trade in oil increasing and the deficit on non-oil trade decreasing. Total exports were some 7 1/2 percent higher than in the previous three months, with exports of manufactures up by 6 percent. Total imports were some 1 1/2 percent lower than in the previous three months, with higher imports of oil, basic materials, and intermediate goods more than offset by declines in other imports. By volume, non-oil exports grew by 3 1/2 percent, while non-oil imports fell by 5 1/2 percent.

III. Financial Policies

Commercial banks' base lending rates were raised to 14 percent in January, in two steps totaling 4 1/2 percentage points. The most recently available statistics on the monetary aggregates are for banking January (December 13 to January 16). These show, on a seasonally adjusted basis, that for the 11 months of the target period so far (February 16 to January 16), Mo grew at an annual rate of 6 percent and £M3 at 10 percent. The expansion of Mo was thus brought back to the center of its 4-8 percent target range, and £M3 to just within its 6-10 percent range, where it has been for most of the target period. Also conforming with the pattern of previous months, PSL2 registered an annualized rate of growth in excess of 15 percent. Bank lending to the private sector was the principal source of the growth in broad money, rising much faster than trend, and more than offsetting the seasonally adjusted decline in the PSBR. In turn, the growth of £M3 was held in check by the continuation of the overfunding program, with gilt sales substantially exceeding the PSBR.

The original forecast for the public sector's budget in the 1984/85 financial year was for a PSBR of £7.2 billion, which was revised to £8.5 billion in the Autumn Statement. In January, the Public Expenditure White Paper projected an overspend of £200 million more than in the Autumn Statement, largely on account of the miners' strike and unemployment benefits, but this was predicated on an ending of the strike late in 1984. While the weekly costs of the strike in 1985 were below the £100 million incurred during its peak, they were not insignificant. Furthermore, interest payments on debt are excluded from these projections and are expected to total some £1 billion more than initially planned. While oil revenues should also be higher because of the appreciation of the U.S. dollar, and despite the decline in the PSBR in the financial year to date to £7.8 billion 1/ in January from £10.3 billion in December (Table 1), the final PSBR may still overshoot the Autumn Statement's projection.

The White Paper announced a three-year real spending freeze in terms of the original 1984/85 budget. The overspend in 1984/85 is to be recouped mostly in 1985/86, when in cash terms spending is to rise by 3.1 percent against a projected inflation rate of 4 1/2 percent. These projections are based on a 3 percent public pay increase and cuts in local budgets of 7 percent in real terms. In the following two years, the increase in spending is to be limited to 3.5 percent, while inflation is projected to be 4 percent in 1986/87 and 3 1/4 percent in 1987/88. On these projections, public spending in 1987/88 would amount to 39 1/2 percent of GDP--i.e., a return to the level of 1979/80--compared to the 43 1/2 percent peak reached in 1981/82 and the 42 1/2 percent now expected for 1984/85. The only areas for which real increases over the three-year period are planned are social security (3 1/2 percent) and health and personal services (2 percent).

IV. Exchange Rate Developments

Between January 1 and the second step of the rise in banks' base lending rates on January 28, sterling dropped by 4 1/2 percent vis-à-vis the U.S. dollar and 3 1/2 percent in nominal effective terms (Table 2). Factors behind the downward pressure on sterling included the persistent expansion of £M3 at the top of its target range and the rapid growth of PSL2; overfunding in response to the unabating growth of bank lending to

1/ Not seasonally adjusted.

the private sector; and reliance on asset sales to restrain the PSBR. However, between the January 28 tightening of monetary policy and February 28, sterling appreciated by 1 percent in nominal effective terms. It depreciated by a further 2 percent against the U.S. dollar over the same period, largely reflecting the strength of that currency against all European currencies.

Table 3 and Chart 1 depict the recent evolution of the United Kingdom's real effective exchange rate in terms of relative normalized unit labor costs. On this measure, the pound sterling depreciated by 10.4 percent between the last Article IV consultation in February 1984 and January 1985. 1/ These calculations are based on data on unit labor costs through the third quarter of 1984 and staff estimates, based in part on developments in hourly compensation, for the period since then. In February 1985 the appreciation of sterling in nominal effective terms reversed some of the earlier depreciation. The effective depreciation in real terms over the 12-month period is thus estimated to have been 10.1 percent.

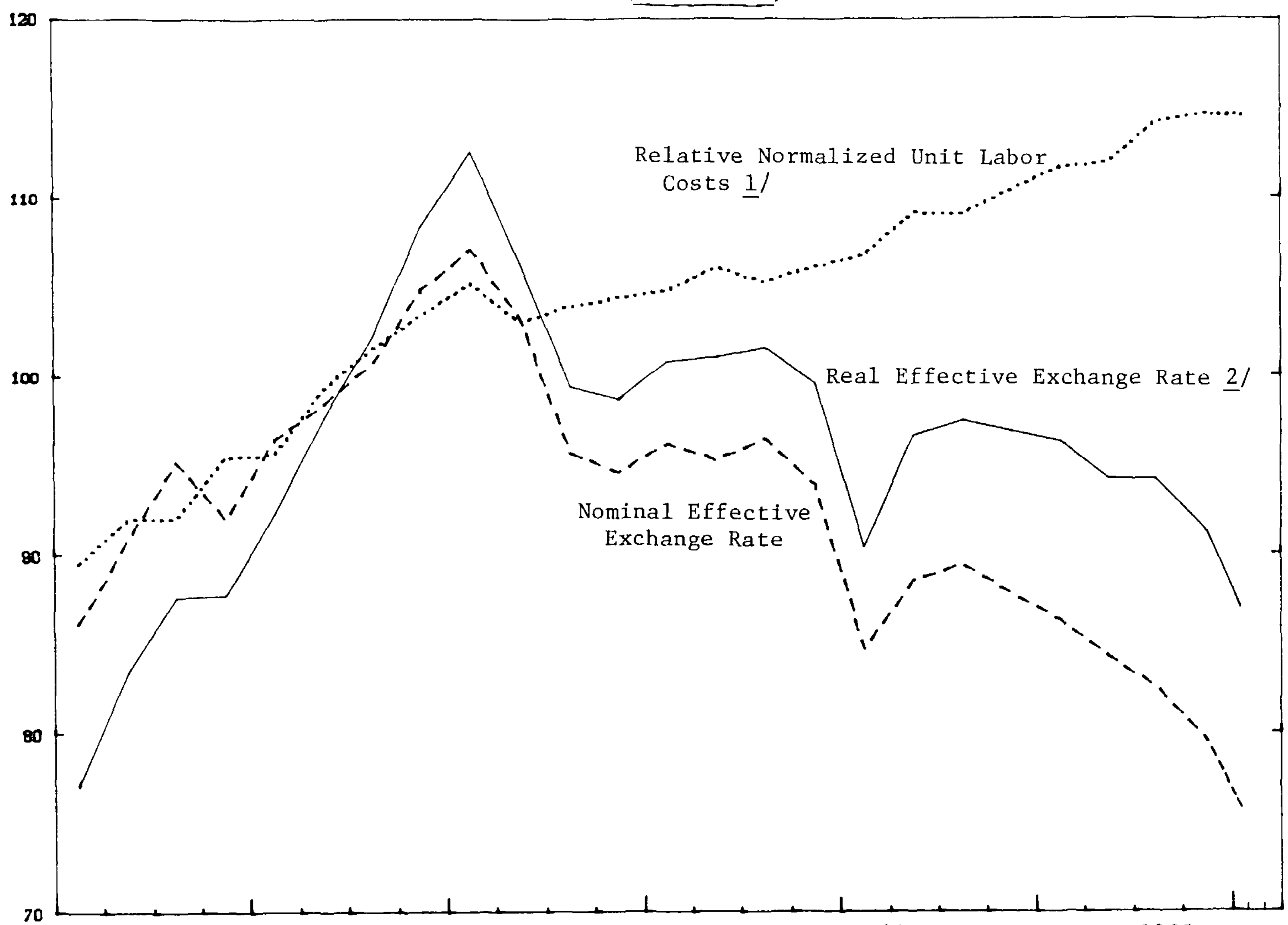
1/ The real effective depreciation in terms of relative consumer prices is also estimated to have amounted to 10.4 percent.

CHART 1

UNITED KINGDOM

INFORMATION NOTICE SYSTEM INDEX OF REAL EFFECTIVE EXCHANGE RATE

(1980 = 100)



1/ In local currency terms. Data for the last quarter of 1984 and for January 1985 are staff estimates.

2/ Trade weighted index of nominal exchange rates deflated by relative normalized unit labor costs; increases mean appreciation.

Table 1. United Kingdom: Public Sector Borrowing Requirement 1/

(Cumulative figures; in billions of pounds)

	1982/83	1983/84	1984/85
April	0.8	1.2	2.4
May	1.8	2.4	3.6
June	2.7	3.2	4.6
July	3.1	3.9	5.2
August	4.2	5.6	6.8
September	4.4	6.9	7.5
October	4.6	7.1	8.0
November	5.5	8.5	9.6
December	7.1	9.8	10.3
January	5.1	7.1	7.8
February	6.0	7.5	
March	8.9	9.7	

Sources: CSO and H.M. Treasury.

1/ Not seasonally adjusted.

Table 2. United Kingdom: Exchange Rates for Pound Sterling

(Last working day unless otherwise specified)

	U.S. Dollars Per Pound Sterling	Nominal Effective Exchange Rate Index (1975 Average = 100) 1/
1979	2.2250	90.2
1980	2.3920	101.4
1981	1.9110	90.9
1982	1.6175	84.3
1983	1.4520	82.9
1984	1.1590	73.0
August	1.3098	78.1
September	1.2387	76.6
October	1.2167	74.9
November	1.2037	74.9
December	1.1590	73.0
1985		
January 11	1.1245	71.3
January 14 2/	1.1110	71.8
January 15	1.1200	71.3
January 25	1.1105	70.6
January 28 3/	1.1110	70.5
February 28	1.0870	71.3

Sources: Bank of England, Quarterly Bulletin; and Financial Times.

1/ MERM weights.
2/ Base lending rates were increased by 2 1/2 percentage points.
3/ Base lending rates were increased by 2 percentage points.

Table 3. United Kingdom: Real Effective Exchange Rate and Related Series 1/

(Indexes: 1980 = 100)

	Real Effective Exchange Rate 2/ 3/	Nominal Effective Exchange Rate 2/	Relative Normalized Unit Labor Costs (local currency) 4/	Normalized Unit Labor Costs	Exchange Rate (U.S. dollars per Pound Sterling) 2/
Quarterly					
1979					
I	77.1	86.1	89.5	81.6	86.6
II	83.5	90.8	91.9	84.9	89.4
III	87.6	95.2	92.0	86.3	95.9
IV	87.7	91.9	95.4	90.7	92.8
1980					
I	92.2	96.5	95.6	92.5	96.9
II	97.7	98.4	99.2	98.1	98.2
III	102.2	100.6	101.5	102.9	102.4
IV	108.3	104.8	103.4	106.5	102.6
1981					
I	112.6	107.1	105.1	109.6	99.3
II	106.3	103.2	103.0	109.3	89.5
III	99.4	95.7	103.8	112.2	78.9
IV	98.7	94.6	104.4	113.4	81.0
1982					
I	100.8	96.2	104.8	116.3	79.4
II	101.1	95.3	106.1	119.0	76.5
III	101.5	96.5	105.2	119.4	74.2
IV	99.6	93.9	106.1	121.4	70.9
1983					
I	90.4	84.6	106.7	122.8	65.9
II	96.6	88.5	109.1	125.9	66.9
III	97.5	89.4	109.0	126.4	64.9
IV	96.9	87.8	110.4	128.8	63.2
1984					
I	96.3	86.3	111.6	131.0	61.7
II	94.3	84.2	111.9	132.3	60.0
III	94.1	82.4	114.2	135.4	55.8
IV	91.2	79.5	114.7	136.5	52.3
Monthly					
1984					
Feb. 5/	96.9	86.8	111.6	131.0	61.9
March	95.3	85.4	111.5	131.3	62.6
April	94.1	84.3	111.6	131.7	61.2
May	94.6	84.6	111.9	132.3	59.7
June	94.4	83.8	112.5	133.3	59.2
July	93.7	82.7	113.4	134.4	56.8
Aug.	94.6	82.9	114.2	135.4	56.5
Sep.	93.8	81.8	114.7	136.1	54.1
Oct.	91.9	80.0	114.8	136.4	52.4
Nov.	91.9	80.1	114.7	136.5	53.4
Dec.	89.8	78.4	114.5	136.5	51.0
1985					
Jan.	86.8	75.8	114.5	136.8	48.5
Percentage change					
Feb. 1984–Jan. 1985	-10.4	-12.6	2.6	4.4	-21.5

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 last quarter of 1984 and for January 1985 are staff estimates.
5/ Date of latest consideration by Executive Board.