BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D.C. 20551

June 11, 1976

CONFIDENTIAL (FR)
CLASS II FOMC

TO: Federal Open Market Committee

FROM: Arthur L. Broida ALB

Attached for your information is a copy of a staff paper dated June 10, 1976, and entitled "The U.K.'s Economic Situation."

Attachment

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date June 10, 1976

To Mr. John E. Reynolds

Subject: The U.K.'s Economic Situation

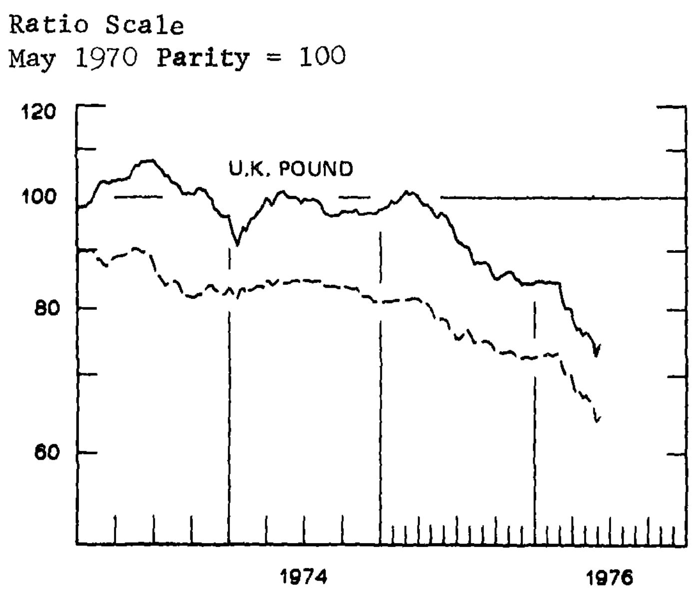
From David H. Howard

RESTRICTED

Between December 5, 1974 and June 4, 1976, the British pound depreciated 26 per cent on a trade-weighted basis. Although most of the depreciation can be explained by such factors as the U.K. inflation rate -- higher than that of the rest of the industrialized world -- and its large current account deficit, the sharp decline that began on May 13 did not appear to be warranted by the U.K.'s current economic situation and prospects. On June 7, 1976, it was announced that the Federal Reserve System would participate along with the U.S. Treasury and the central banks of other Group of Ten countries, Switzerland, and the Bank for International Settlements in making available to the Bank of England standby credits totalling $5.3 billion. Of the total amount, the Federal Reserve System will stand ready to make available $1 billion under the $3 billion swap arrangement with the Bank of England.

This note provides background material to these arrangements covering recent exchange market developments, the U.K. domestic economic situation and prospects, the U.K. government's external debt and reserve position, and its external sources of credit. The chart below shows the course of sterling since the end of 1972.

RESTRICTED



Dollar Price (Solid Line) and Weighted Average Value (Dashed Line)

Exchange Market[1/]

Between December 1974 and December 1975, the pound sterling depreciated 13 per cent against the dollar and 11 per cent on a trade-weighted basis. From early December 1975 until March 4, the exchange rate for sterling fluctuated within a narrow range. On March 4, sterling resumed its decline, and by April 23 it had depreciated an additional 10 per cent both against the dollar and on a trade-weighted basis. Between March 5 and April 23, the Bank of England sold $2.9 billion in an effort to moderate sterling's decline. The Bank of England's Minimum Lending Rate (MLR) was reduced 1/4 per cent to 9 per cent on March 5. This was the last in a series of small reductions in the MLR that started in November after it had been raised to 12 per cent. Despite the downward pressure on sterling, the MLR was kept at the 9 per cent level until April 23 when it was raised to 10-1/2 per cent. Between April 23 and

1/ See the second page of the attached table.

May 12 sterling fluctuated in value but there was little net change over the period. On May 13, sterling entered another period of sharp decline -- falling 6.6 per cent against the dollar between May 12 and June 4. On May 21, the Minimum Lending Rate was raised to 11-1/2 per cent, apparently in an effort to protect sterling's external value. The rate of dollar sales by the Bank of England diminished during this period -- presumably reflecting British concern over the low level of official reserves -- and the exchange rate for sterling was subject to wide intra-day movements accompanied by a widening of bid-offer spreads.

There does not appear to be a single dominant explanation for sterling's sharp decline between May 12 and June 4. Uncertainty over the second phase of the U.K. incomes policy no doubt was a factor since throughout the last month or so various unions have expressed either their support or opposition to the policy. Similarly, worries about the prospects for the public sector borrowing requirement, public spending, and money supply growth -- triggered by recent news of overexpenditures by local governments and April money supply figures that showed a sharp increase in bank lending to the private sector -- probably contributed to the general loss of confidence is sterling. Furthermore, on May 14 unfavorable monthly data on U.K. trade, inflation, and industrial production were announced. However, the underlying trend in each of these series is favorable. Finally, the market was uncertain what the U.K. government's policy was toward the exchange rate of sterling.

On June 7 -- the day of the announcement of the standby credits -- sterling increased by about 3 per cent to $1.77 with only a very small amount of support by the Bank of England. On June 8, sterling initially rose

1-1/2 per cent but later fell back to about $1.77. On June 8 and 9, the Bank of England intervened heavily to keep the pound from falling much below the $1.77 level.

The Current Economic Situation[1/]

The U.K. economy is in the midst of a moderate upturn. Industrial production and GDP have been rising, export volume has been increasing strongly (10 per cent SAAR between October and April) and the current account deficit has been improving since the third quarter of last year. (The unfavorable April trade figures were much influenced by special factors -- diamond and oil-related imports.) Unemployment has been essentially constant (at a high level) since February, although the rate edged up in May.

Price and wage inflation have moderated since last summer and, at least until the sharp decline in the external value of sterling in recent months, it looked as if the government might achieve its goal of reducing the rate of increase in retail prices to 10 per cent by December, as measured by December 1976 over December 1975. However, U.K. price performance and prospects remain worse than those of most of its trading partners.

Money stock growth in the United Kingdom has been somewhat erratic in recent months. Between October 1975 and January 1976 the money stock was virtually constant; but since January, as the attached table shows, growth rates have increased substantially. Interest rates

1/ The attached table presents some data on selected economic indicators.

declined in February and remained essentially unchanged until April 22 when the Bank of England took action to raise them. Since then, interest rates have been increasing.

Economic Prospects

Real GDP is expected to grow at an annual rate of 3 to 4 per cent during the next four quarters, with a retail price inflation rate around 12-13 per cent. The current account deficit will probably be about £1-1/4 billion in 1976 compared with £1.7 billion in 1975. North Sea oil should start to make a significant positive, net contribution to the current account by the end of 1976. The public sector borrowing requirement (in nominal terms) for fiscal year 1976-77 is estimated by the U.K. government to be £12 billion; it was £10-3/4 billion last year.

In the April Budget as well as in the February White Paper on public expenditure, the U.K. government stated its intention to limit the growth of public spending and to promote industrial investment and production for export.[1/] The Budget introduced some measures aimed at promoting investment, and the price control system is being reviewed with the aim of increasing investment incentives. However, at least until recently, the government apparently believed that political considerations prevented any significant cuts in public spending -- and hence the deficit -- while unemployment is so high. Although the left wing of the Labour Party has been pressing for import controls, so far the government has resisted the pressure -- except for a few minor trade restrictions that were imposed last December.

1/ The movement in the exchange rate of sterling since March has, of course, helped to achieve this last objective.

A continuing source of uncertainty about the U.K.'s future is the second stage of the incomes policy. On May 5, representatives of organized labor and the government agreed to an average limit of 4-1/2 per cent on wage raises during the twelve months starting August 1. Such an agreement, if successfully implemented, should be considered a major achievement. A special conference of the Trades Union Congress will be held on June 16; it is expected to approve the agreement. However, some individual unions have announced their opposition to the agreement. (The present £6 per week limit to wage increases was also opposed by some unions but there have been no known violations of the limit.)

The size of the public sector borrowing requirement and how it will be financed are two other sources of uncertainty regarding the U.K.'s economic prospects. Until the government shows that it can and will cut, or at least control, the deficit, this uncertainty probably will continue. Although the Chancellor hinted at a money supply growth target in his Budget message -- M_3 growth equal to the growth in nominal GDP -- it is not clear how seriously the government regards the target or even the need for control over the growth of monetary aggregates. Until this situation is clarified, uncertainties about how the deficit will be financed will continue, and the possibility of excessive money supply growth will continue to worry many observers. In connection with the recently announced standby arrangements, the U.K. government has indicated its seriousness about taking positive steps in these areas. In particular, on June 7, Chancellor Healey stated that the government was determined to keep public spending under control and that money supply growth would not be allowed to reaccelerate inflation. However, the Chancellor stated that no actual changes in current public expenditure plans were justified at this time. The Chancellor also ruled out any new exchange market controls or import restrictions. On the same day, the Bank of England announced the issue of a new long-term government bond, totalling £.8 billion, which should help to finance the public sector borrowing requirement and reduce money supply growth through sales to the nonbank public.

The U.K. Government's External Debt

The U.K. government has recently borrowed SDR 1 billion (about $1.15 billion) under the IMF Oil Facility, and drawn around another SDR 1 billion in two installments -- the remainder of its IMF gold tranche and SDR .7 billion of its first credit tranche. As of the end of May, U.K. public sector bodies owed some $7.5 billion in dollar-denominated loans, and about $.9 billion equivalent in loans denominated in other foreign currencies. At the end of 1975 there was £4.1 billion in exchange reserves in sterling held by central monetary institutions, i.e., official sterling balances. Of this amount, some £2.8 billion was held by oil-exporting countries. In addition, there was £3.2 billion outstanding in banking and money market sterling liabilities to external holders other than central monetary institutions, of which £.5 billion was held by oil-exporting countries.[1/]

1/ Of the official sterling balances, £2.7 billion was owed by the U.K. public sector; virtually none of the banking and money market liabilities to external holders other than central monetary institutions was owed by the U.K. public sector.

Little information is available on the behavior of official sterling balances during the recent decline of sterling. However, according to the Bank of England, sales of sterling balances were not substantial in March but heavy sales did occur in April, at least by the oil-exporting countries. On April 21, such countries held some £2.3 billion in official sterling balances.

The U.K.'s Reserve Position

Exchange market intervention during recent months has depleted U.K. reserves, despite the drawings from the IMF in January and May and various public sector loans throughout the year. The attached table shows the movement in U.K. reserves. At the end of May, total U.K. reserves stood at $5.4 billion; of this, $.9 billion is gold valued at $42.22 per ounce, and $.8 billion is SDR's. The remaining $3.7 billion is in foreign currencies.

The U.K.'s Sources of External Credit

1. The International Monetary Fund

The United Kingdom can take advantage of the temporary 45 per cent increase in potential access to the IMF credit tranches and draw an additional $360 million that would exhaust its first credit tranche. It has three remaining credit tranches -- totalling about $3.5 billion including the increase in potential access. Drawings on these upper tranches, however, would involve the imposition by the IMF of conditions on the U.K.'s economic policies such as quantitative targets regarding the public sector deficit. The U.K. government has agreed to borrow from the IMF, if necessary, in order to pay back drawings on the standby credits announced on June 7 that remain outstanding on December 9, 1976.

2. The European Economic Community

The EEC has a short-term borrowing facility of $2.5 billion and a medium-term one of $2.8 billion. However, most of these resources have been committed to Italy, and so the United Kingdom cannot rely on the EEC for much help. The U.K. could, however, withdraw its share ($.4 billion) of the EEC loan to Italy. The EEC also has an oil facility, but only $.7 billion of this is now available.

3. The OECD "Safety Net"

The OECD Financial Support Fund has not yet been ratified by the U.S. Congress, and it may never win Congressional approval. However, if it were implemented as presently planned, the U.K.'s potential drawing rights would be about $3.6 billion.

4. Other Sources of Credit

U.K. public sector bodies have been successful at borrowing abroad and are expected to continue to be successful. There are reports that commercial banks are willing to lend to the U.K.'s nationalized industries and the U.K. Treasury itself. There are confidential reports that the Saudi Arabian Monetary Authority has been secretly lending dollars to the U.K. public sector ($.3 billion in April) and is willing to continue doing so. Finally, two-thirds of a $1.2 billion loan from Iran arranged in 1974 remains to be drawn; two installments of $.2 billion each are expected to be drawn this year (in June and September), with another $.4 billion to be drawn in 1977. However, Iran has already postponed this loan once and may do so again, if not renege altogether.

RESTRICTED

United Kingdom: Selected Economic Indicators

	1975 Q1	1975 Q2	1975 Q3	1975 Q4	1976 Q1	1976 Feb.	1976 Mar.	1976 Apr.	1976 May
Production (percentage change from preceding period, SAAR)									
GDP (based on output data)	0.7	-9.5	-1.9	2.7	4.5	n.a.	n.a.	n.a.	n.a.
Industrial production	-0.4	-17.3	-1.0	0.8	5.3	10.7	2.4	-7.1	n.a.
Prices and Wages (percentage change from preceding period, annual rate)									
Retail prices	26.3	43.5	18.7	14.5	15.2	15.4	6.4	23.1	n.a.
Wholesale prices	30.0	25.4	16.1	12.5	16.3	14.2	6.9	16.1	n.a.
Average earnings (SA)	19.9	17.2	33.6	17.0	11.9	4.3	20.2	n.a.	n.a.
Unemployment (Great Britain, seasonally adjusted)									
Average Level (thousands)	706	811	959	1087	1174	1185	1179	1186	1200
As per cent of employees	3.1	3.6	4.2	4.8	5.2	5.2	5.2	5.2	5.3
Money supply (percentage change from preceding period, SAAR)									
M_1	24.3	15.0 1/	22.1	11.7	14.6	45.0	10.0	24.0	n.a.
M_3	11.1	8.5	11.0	6.9	8.1	17.5	5.4	15.3	n.a.

1/ Break in series in May 75. Q2 average estimated.

RESTRICTED

	1975 Q1	Q2	Q3	Q4	1976 Q1	Feb.	Mar.	Apr.	May
Current Account (£ millions, seasonally adjusted)									
Balance of Merchandise Trade of which:	-850	-681	-986	-683	-431	-244	-16	-255	n.a.
Petroleum	-766	-689	-795	-864	-956	-338	-284	-336	n.a.
Other	-84	8	-191	181	525	94	268	81	n.a.
Net services and transfers	415	345	361	377	360	120	120	120	n.a.
Current account balance	-435	-336	-625	-306	-71	-124	104	-135	n.a.
Official foreign reserves ($ millions)									
Level at end of period	7117	6198	5859	5429	5905	7024	5905	4848	5423
of which, foreign exchange	5127	4184	3783	3335	4177e	5296e	4177e	3120e	3695e
Change during period	+328	-919	-339	-430	+476	+239	-1119	-1057	+575
Estimated intervention	368	-755	205	424	-900	-187	-1130	-1196	-758

e = estimated.

	1974 12/27	1975 6/27	12/26	1976 2/27	3/26	4/30	6/4	6/9
Exchange Rate								
U.S. cents per £	232.70	222.35	202.30	262.69	192.08	184.10	171.70	177.10
Effective rate (Bank of England; percentage depreciation since December 21, 1971)	-21.4	-27.6	-30.2	-30.2	-33.8	-36.9	-41.2	-39.1
Interest rates and equity prices								
3-month interbank sterling	12.56	9.75	11.16	8.81	8.56	9.94	11.50	10.88
Yield on perpetuities (3-1/2% War Loan)	17.20	14.60	14.75	13.46	13.80	13.48	13.96	n.a.
Index of industrial stock prices (Financial Times Industrial Ordinary)	159.6	295.6	363.4	405.2	410.4	418.1	378.5	379.2