Research Department
Federal Reserve
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Britain's Borrowed Time

John Bull dropped the other shoe last week, when the Government announced a £ 1.5-billion reduction in planned public-sector borrowing for next year, involving a combination of stiff spending cuts and higher social-security taxes. This dose of fiscal restrictiveness, coupled with tighter monetary and incomes policies, represented Britain's response to last month's $5.3-billion international aid package, which gave the nation a welcome breathing spell while it began to attack its underlying economic problems. Britain's problems became painfully evident last spring, as the pound sterling crashed through its $2.00 psychological floor in early March and didn't stop until it reached $1.70 in early June, rebounding only with the announcement of the international rescue effort.

PPP and all that
Up until recently, sterling depreciation could be explained by the fact that inflation was far worse in Britain than among her major trading partners. During 1975, the U.K.'s 20-percent wholesale price inflation compared with only 3 percent in Germany, 5 percent in the United States, 6 percent in the Netherlands, and 9 percent in France. Relative to her competitors, Britain's domestic wholesale prices rose about 15 percent on a trade-weighted basis during this period—and this was matched by a 15-percent effective depreciation in exchange rates, in a neat demonstration of the theory of "purchasing-power parity."

According to the theory, when domestic prices rise higher in one country than in others, the result is a stimulation of import demand and a dampening of export demand, and a consequent weakening of that country's exchange rate. Maintenance of a currency's purchasing-power parity vis-a-vis trading-partner currencies requires that inflation-rate differentials be offset by exchange-rate changes.

However, this spring's severe 16-percent depreciation of sterling far exceeded the decline which would be warranted by current inflation-rate differentials. Indeed, the pound at that point was undervalued by at least 4-6 percent in terms of purchasing-power parity, with 1974 as a base year. Exchange rates, of course, respond to many other factors besides price changes—short-run expectational factors and interest-rate differentials being especially important.

In the case at hand, uncertainties over British economic prospects apparently created a temporary downward bias in market expectations and led to an exaggerated selling bout against the pound on the part of speculators and holders of short-term sterling balances. The obvious cure for this unstable situation was the $5.3-billion package of standby credits, which was designed to preserve "orderly conditions" in foreign-exchange markets. Indeed, the announcement of the credits accomplished its purpose. The pound immediately increased about 5 percent in value, to

(continued on page 2)

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around $1.77, and thereafter remained near that level, helped along by the Chancellor of the Exchequer's statement that government policy was to maintain a stable exchange rate rather than to try to force it higher.

Policy gamble

In the light of this policy posture, Britain's borrowed bankroll may be interpreted as a gamble which hinges on whether or not the holders of sterling balances (including speculators) are convinced of the Bank of England's ability to maintain a stable exchange rate. Should the gamble succeed, several important consequences would be likely to follow. The discount of forward sterling (the cost of covering investments in sterling) would come down. A decline in the forward discount, coupled with higher interest rates than abroad, would attract short-term funds back into London. Finally, the Bank of England could rebuild its reserves and repay any drawings on the standby credits.

On the other hand, should the gamble fail, a temporarily stable exchange rate would afford the holders of sterling balances an opportunity to get out of sterling while the going was good, with the Bank of England footing the bill. Britain might then find it difficult to repay heavy credit drawings from her official drawings, and would be forced to turn to the International Monetary Fund for a medium-term loan which could have tightly restrictive terms.

The Government thus was keenly aware that its gamble would have to succeed, and yet equally aware that defending the value of the pound would depend on its success in the very difficult task of controlling domestic inflation. During the last several years, a growing budget deficit has contributed to an inflationary "demand pull," while a wage explosion, which peaked at a 30-percent annual rate in mid-1975, provided a strong "cost push" argument.

Restrictionism

Britain's public-sector deficit (including nationalized industries) escalated from £4.3 billion in fiscal 1974 to about £12.0 billion in the current fiscal year, leading to fears both of increased inflationary pressures and of a crowding-out of private borrowers from financial markets. In an early effort to control the fiscal 1976 budget, the government placed cash ceilings on two-thirds of budgeted expenditures. However, real spending plans were based on an assumed inflation rate which is now likely to be too low due to the inflationary effects of sterling's recent depreciation. Thus, the maintenance of spending ceilings would probably require real reductions in some areas. In addition, the £1.0 billion in fiscal 1977 spending cuts announced last week—affecting regional development grants, nationalized industries' capital spending, road building, food subsidies, defense spending, home building and social services—obviously would mean even deeper cuts in real terms.

Restrictive policies have slowly evolved in other areas as well. Between fiscal 1975 and fiscal 1976 (ending March), the growth of the broadly defined money supply (M_3) decelerated from 14 percent to 9 percent. Some deceleration was also evident in the growth of the narrowly defined money supply (M_1), although that measure continued to expand between the two full fiscal years. Meanwhile, in the latest version of the "social contract" between the Government and the trade unions, a 4.5-percent ceiling was placed on average wage increases over the next twelve months. On the other hand, the wage agreement was coupled with income-tax cuts which could aggravate the budget deficit.

The objective of all these measures is to reduce inflation to single-digit figures by the end of this year—a difficult task in view of the lingering effects of earlier overstimulative policies and the inflationary impact of sterling depreciation. In particular, the unions are likely to be made restless by the reduction in living standards caused by depreciation and now by cuts in social programs, coming at a time when the jobless rate (at more than 5.5 percent) has reached the highest level of the past generation. But the alternative, unfortunately, is reduced living standards through further inflation.

Road back?

Any success achieved in this anti-inflation drive should bode well for British exports, permitting the nation to build on the price appeal of British goods resulting from sterling depreciation. This factor, plus the worldwide business recovery, could generate an export boom which would help drag the U.K. out of its economic slump and, by improving her trade balance, help restore confidence in the pound.

The $5.3-billion credit package, by restoring short-term sterling stability, has bought time for Britain's domestic anti-inflation policies to take hold. Over the long term, confidence in the stability of the pound, as well as prospects for sustained recovery, will depend upon the British Government's continued ability to perform a difficult balancing act. At one end of the balancing pole are the real wage expectations of Britain's powerful labor unions and the nation's social objectives. At the other end are the more general economic goals of reduced inflation and balanced economic growth. In view of Britain's trading position in the world and the role of sterling as an international reserve-and-transactions currency, the rest of the world also has a high stake in Britain's balancing skill.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT
(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 7/14/76	Change from 7/07/76	Change from year ago Dollar	Percent
Loans (gross, adjusted) and investments*	88,841	+ 53	+ 2,960	+ 3.45
Loans (gross, adjusted)—total	66,892	– 260	+ 2,327	+ 3.60
Security loans	1,459	– 28	+ 517	+ 54.88
Commercial and industrial	22,178	– 33	– 967	– 4.18
Real estate	20,166	+ 35	+ 497	+ 2.53
Consumer instalment	11,218	– 24	+ 1,218	+ 12.18
U.S. Treasury securities	9,648	– 18	+ 1,029	+ 11.94
Other securities	12,301	+ 331	– 396	– 3.12
Deposits (less cash items)—total*	90,004	+ 145	+ 4,127	+ 4.81
Demand deposits (adjusted)	25,797	+ 884	+ 1,868	+ 7.81
U.S. Government deposits	260	– 115	– 68	– 20.73
Time deposits—total*	62,545	– 116	+ 2,440	+ 4.06
States and political subdivisions	6,115	+ 28	– 433	– 6.61
Savings deposits	26,354	+ 104	+ 5,624	+ 27.13
Other time deposits‡	27,405	– 266	– 1,570	– 5.42
Large negotiable CD's	12,413	– 58	– 3,169	– 20.34

Weekly Averages of Daily Figures	Week ended 7/14/76	Week ended 7/07/76	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves	49	28	35
Borrowings	3	8	5
Net free(+)/Net borrowed (–)	+ 46	+ 20	+ 30
Federal Funds—Seven Large Banks			
Interbank Federal fund transactions			
Net purchases (+)/Net sales (–)	+ 845	– 431	+ 1,780
Transactions of U.S. security dealers			
Net loans (+)/Net borrowings (–)	+ 679	+ 180	+ 799

*Includes items not shown separately. ‡Individuals, partnerships and corporations.

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