THE EXCHANGE RATE

17 September 1992

THE EXCHANGE RATE

We are all familiar with the arguments against devaluation, and they have been forcibly put in recent weeks. I had been intending to write to you this week setting out the case for a fall in the exchange rate - a realignment downwards, the Italian exit, or whatever - in case sterling came under pressure after the French referendum. But we have now been overtaken by events, so the best I can do is set out why I think a devaluation could well be a blessing in disguise. This note may also be relevant in the context of decisions about how and when we rejoin the ERM.

Economic background

2. Nobody needs reminding that the economic situation is very difficult. Apart from the inevitable concerns about recovery in the short-term, the medium-term prospect is not very encouraging. GDP is probably now around 5 per cent below trend, and according to most if not all forecasts there was no prospect of it returning to trend in the next three or four years if we had remained in the ERM at the old parity. The current account is in deficit, and the deficit is likely to widen as the economy recovers. Inflation is falling, and at the old ERM parity would have continued to do so. But as we approached very low numbers the going would have become much more tough.

3/a

3. There is a general consensus that domestic demand is likely to remain comparatively weak in the medium-term. The rapid build-up of debt in the 1980s has left private sector balance sheets very weak, and there needs to be a process of retrenchment. This could take some time and the continuing fall in property prices is not helping the adjustment process. Of course this is not just a UK problem.

4. Financial deregulation may mean that the private sector will not aim to run financial surpluses of the same order as in earlier decades. But there is no reason for thinking that it will wish to rush back into financial deficit, as in the late 1980s. The June forecast projected a decline in its surplus from about 4 per cent of GDP in 1992-93 to 1 per cent of GDP in 1996-97, but this did not generate sufficient domestic demand to bring output back on trend. An output gap of nearly 3 per cent remained at the end of the period. It is not clear that we can reasonably expect faster growth of private sector demand than this. And given the present approach to fiscal policy, we cannot look to the public sector to generate additional demand either.

5. So what would bring output back to trend, and how long is it likely to take? The answer is that it probably requires a strong contribution from net trade, which could in principle come about in three ways:

- stronger growth of world demand;
- improved trade performance;
- improved competitiveness.

6. Under the old ERM policy there was no reason for expecting the process of adjustment to be rapid. Our own projections implied that output might get back on to trend towards the end of the decade, and outside forecasts typically showed an even more pessimistic picture. It may be, of course, that the trend is

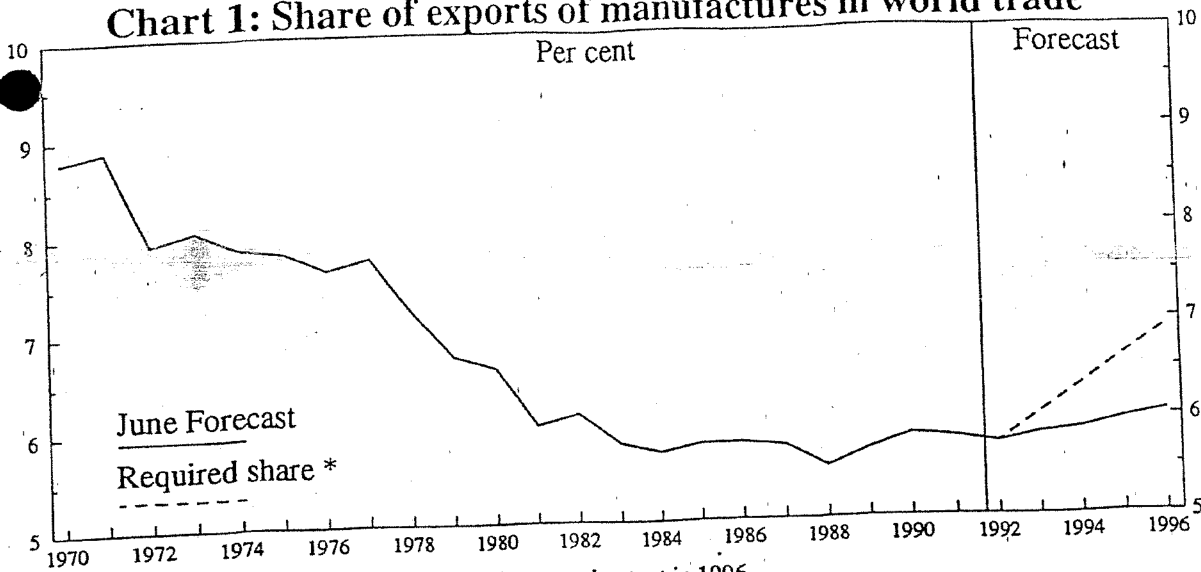
lower than we currently think. But I personally doubt that it is much lower, and I am not inclined to give enormous weight to arguments ~~that the depth of the~~ recession will sharply reduce output capacity in the medium-term. I prefer to think of ways in which the adjustment process might be less protracted than seemed likely in June.

<u>Trade performance</u>

7. Nobody is anticipating more buoyant world demand, given the debt overhang in other countries and the counter inflationary policies being pursued in the Community and elsewhere. But it is certainly possible that UK trade performance could improve. We saw an improvement in the 1980s, when the decline in our share of world trade came to an end and may even have been reversed. With output well below trend for a number of years, and domestic demand remaining weak, producers will have every incentive to divert output on to world markets. But is there any reason for thinking that trade performance might improve in the required manner?

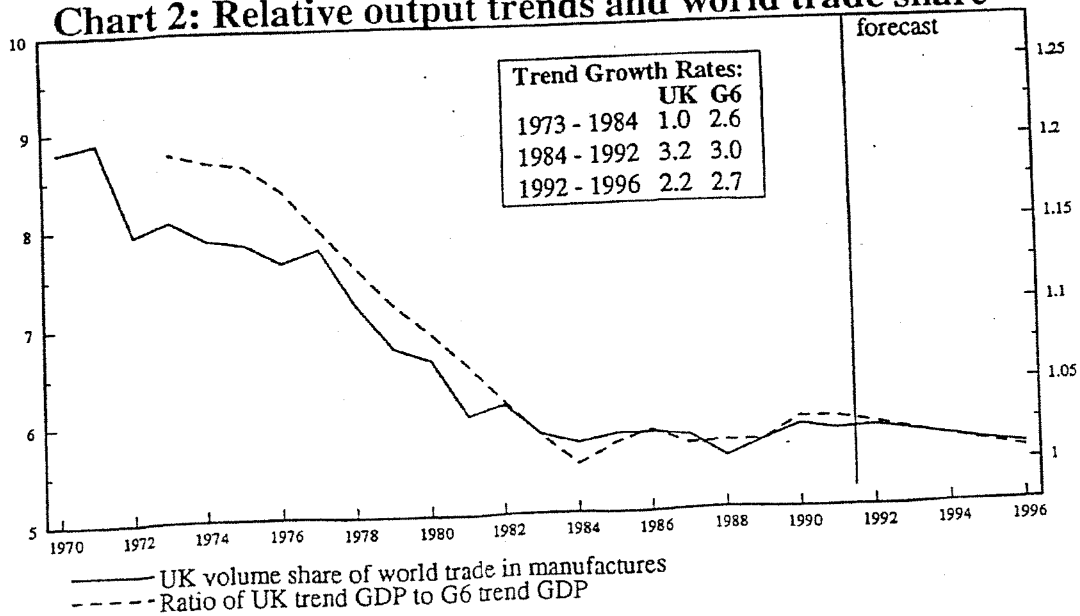
8. Forecasts typically assume a continuation of recent trends in trade performance. The June forecast incorporated a gradual increase in our manufactured export share, taking it from roughly 5¾ per cent in 1992 to around 6 per cent by 1996 - about the same level as the beginning of the 1980s. For purely illustrative purposes, we have looked at what would be required to bring output back on to trend if we had to rely solely on improved export performance. The answer is that the trend in our export share would have to bend upwards quite sharply, taking it to nearly 7 per cent by 1996.

17 September 1992



* UK share of world trade required to achieve trend output in 1996

9. Is it realistic to suppose that we could achieve such a change in performance? After all, it is quite small in relation to the decline in our export share observed during the 1970s. The earlier decline in our share was of course associated with a declining UK share of world output. And during the 1980s, the improvement in our export performance accompanied an improvement in our trend growth rate relative to other countries. This is illustrated in the chart below, which uses the estimates of trend output in other countries recently put together by IF2 and MP2.



THE EXCHANGE RATE

17 September 1992

10. Our current estimates of trend GDP growth in the UK and the other G6 countries do not lead us to expect a further upturn in our export share. If anything we might perhaps expect a renewed downturn: our estimated trend growth has declined from 3¼ per cent in the late 1980s to 2¼ per cent in the 1990s, whereas trend growth in the G6 may slow down only from 3 per cent to 2¾ per cent. This is the direction in which the forecasters are now moving.

11. Estimates of trend output growth are of course very uncertain, but for what they are worth they are not very reassuring. Better trade performance would probably require either lower growth of world capacity than we currently envisage (though not accompanied by lower world demand, which would of course depress exports) or faster growth of trend output in the UK (which nobody is suggesting right now, and would probably imply a even larger output gap).

Competitiveness

12. If we cannot look to improved trade performance to bring about a sufficient growth in net exports, we will need an improvement in competitiveness. With a fixed exchange rate, this means that UK inflation would have to undershoot inflation in competitor countries for a period. The June forecast showed some tendency for this to happen - relative unit labour costs were projected to fall by 6-7 per cent between 1992 and 1996. But this was evidently not enough to bring output back to trend.

13. Conclusions about real exchange rates based on highly uncertain medium-term projections and estimates of competitiveness elasticities which are not very firmly based must inevitably be taken with a pinch of salt. But the conclusion that the real exchange rate is currently too high - or would be at its old central rate against the Deutschemark - is supported by a range of evidence:

- However measured, it is higher than on average in the 1970s and 1980s, whereas arguably it should be lower given the decline in oil prices and North Sea production since the early 1980s. And this is not just a dollar problem, because the same is true when comparing sterling against the ERM currencies. Ironically, however, the only measure which does not support this conclusion is the real sterling/Deutschemark exchange rate measured in terms of unit labour costs. Charts A-D give the details;

- Measures of fundamental equilibrium exchange rates (FEERs) also suggest that sterling is over-valued. Estimates of over-valuation with sterling at its old central ERM parity lie in the range 10-20 per cent;

- The evidence for over-valuation is weakest if one uses purchasing power parity as a benchmark. Goldman Sachs' calculations suggest that if anything sterling is slightly under-valued against the Deutschemark, though not against the French franc or the basket of currencies in the exchange rate index.

14. Our own calculations suggest that the improvement in competitiveness <u>relative to the path in the June forecast</u>* required to generate sufficient net exports to bring output back to trend by 1996 may be in the range 10-20 per cent. Against the ERM currencies the required improvement is on average rather less: say 5-15 per cent. Greater precision than this is probably not warranted in the absence of further detailed work. But these ranges give some indication of the orders of magnitude involved. Note that they refer to <u>real</u> not nominal changes.

15. There are two possible ways in which an improvement in competitiveness might come about:

---

* The June forecast assumed a £/DM rate close to the central parity in the medium term, and a £/$ rate of about 1.75.

- domestic disinflation, designed to reduce UK costs relative to those of our competitors;

- a nominal depreciation of sterling.

16. It is not true to say that the effect of a sterling devaluation on competitiveness will necessary be entirely eroded by higher inflation. Just as a protracted period of output below trend can induce a fall in relative UK prices and costs, so it can also ensure that the effects of a devaluation are not entirely eroded. If an adjustment of the real exchange rate is needed to achieve internal and external balance, this can be achieved by devaluation as long as domestic policies are sufficiently tight.*

17. What is clear is that the devaluation route means a higher price level at the end of the day than the domestic disinflation route. But the only reason for concern would be if the very act of devaluation caused a deterioration in wage setting behaviour, and thus raised the output cost of procuring the required adjustment. We have, of course, argued that ERM membership should lead to better wage performance, with the corollary that devaluation would undermine this. But the evidence for improved wage behaviour in ERM countries is very sparse. We may be in danger of over-stating the risks on this front from a devaluation.

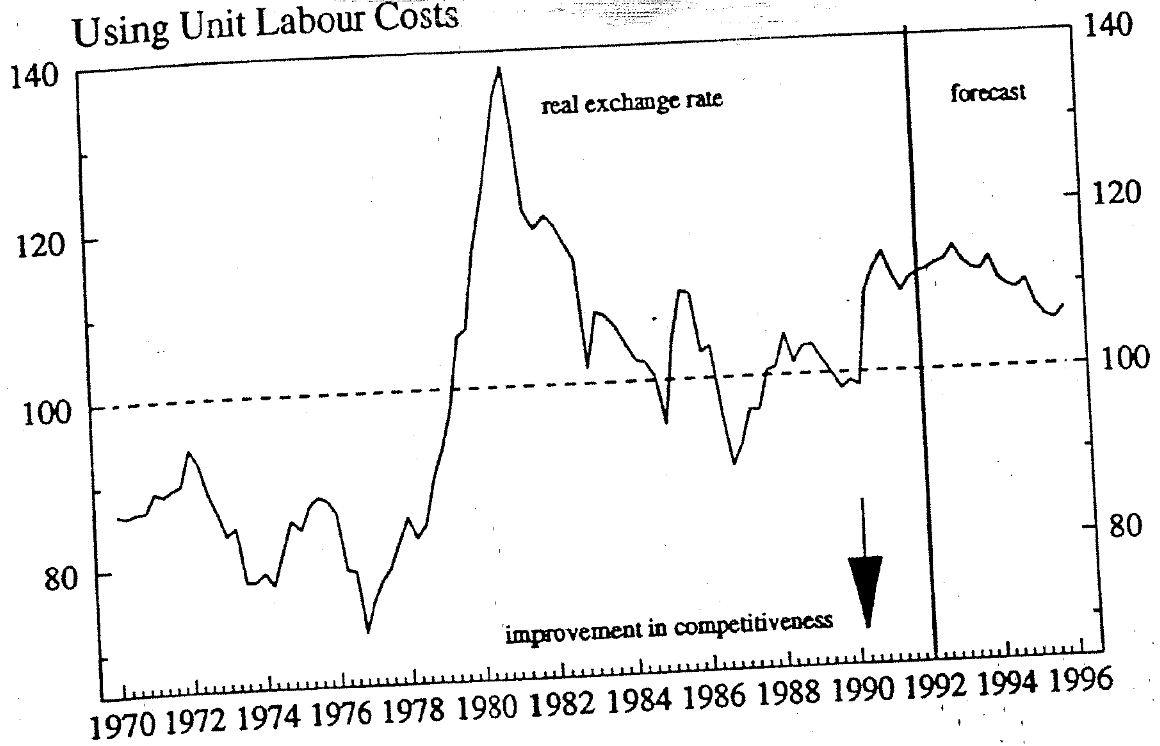
18. But there is evidence that the output/inflation trade-off is worse at low rates of inflation than at higher rates. If we are required to achieve, say, a 10 per cent reduction in the real exchange rate by domestic disinflation, we probably need to ensure that UK inflation falls to zero in the medium term. At these sorts of inflation rates, the output/inflation trade-off may become very unfavourable. The devaluation route would mean higher average inflation over the next few years, and a more favourable trade-off.

---

* The precise relationship between real and nominal exchange rate changes depends, of course, on the accompanying stance of domestic financal policies.

THE EXCHANGE RATE

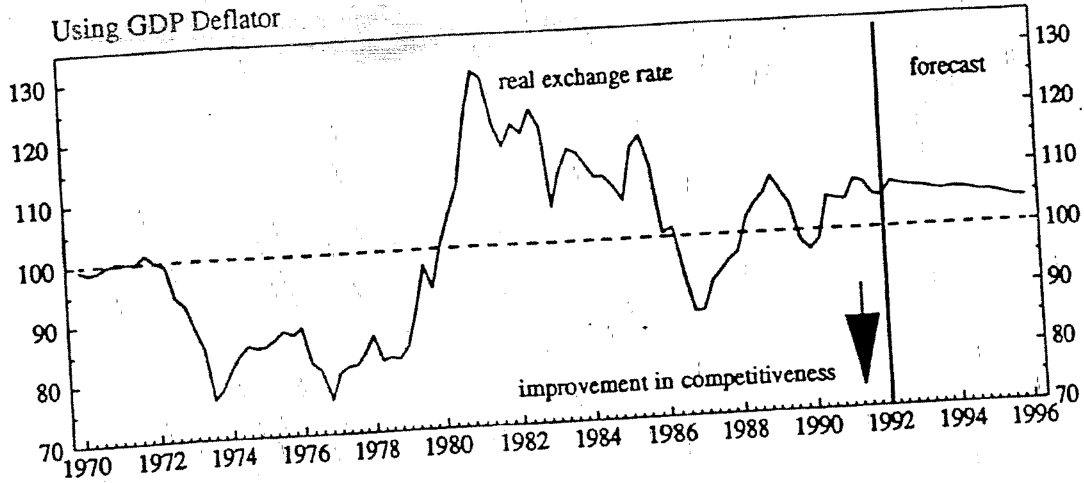
17 September 1992

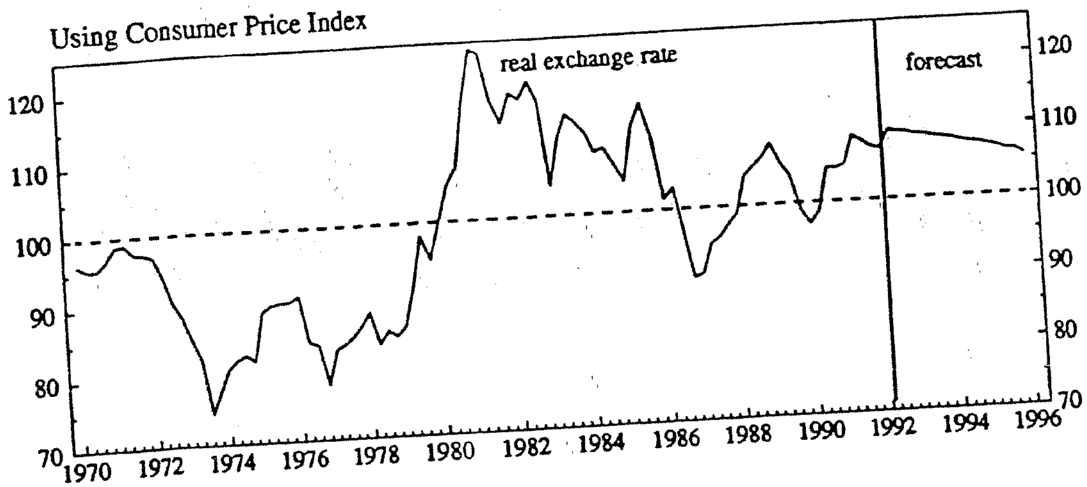


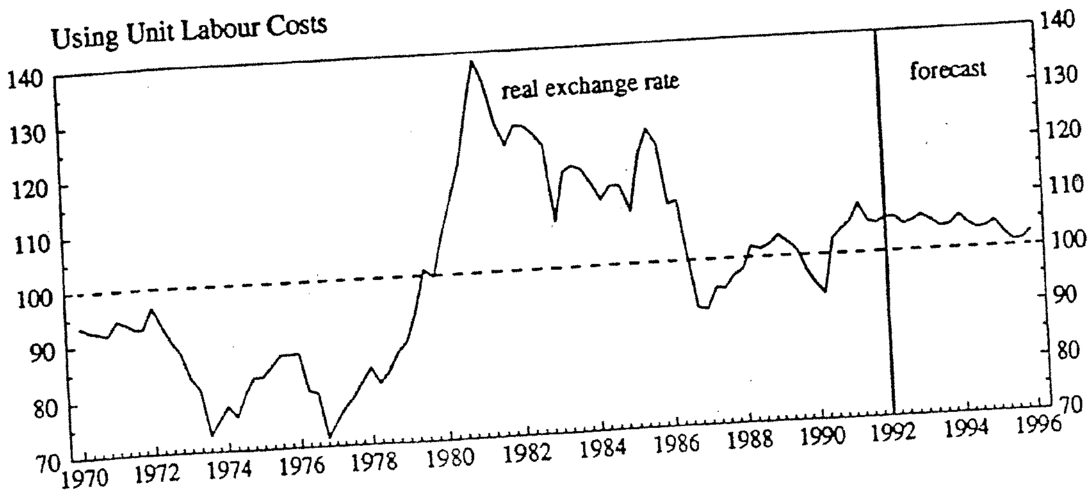
THE EXCHANGE RATE

17 September 1992

Chart B: Real exchange rate against the ERM currencies
Average 1970-1992 =100





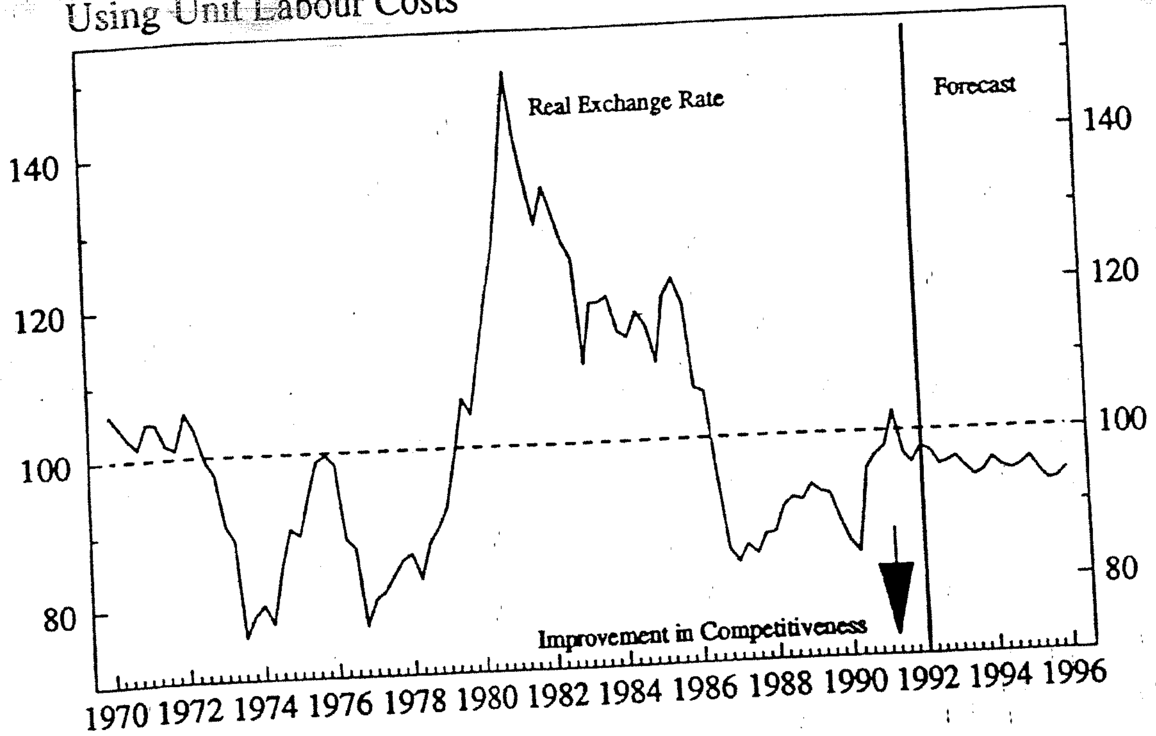


THE EXCHANGE RATE

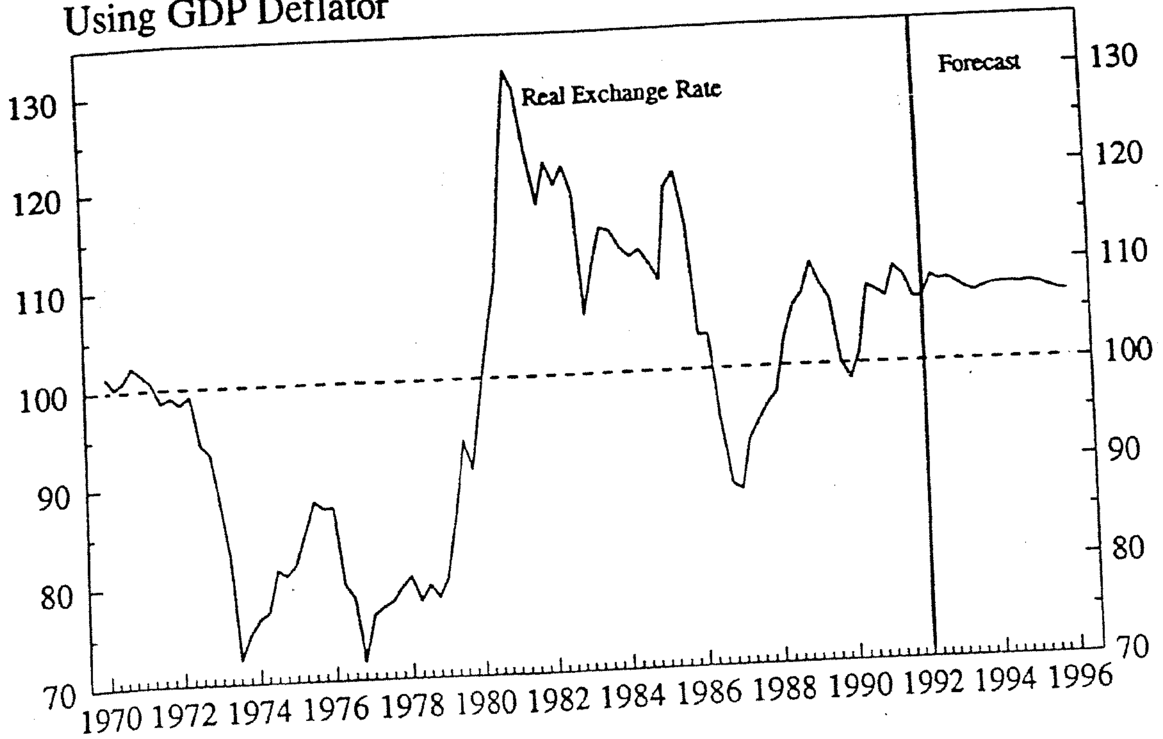
17 September 1992

Chart C: Real Exchange Rate Against the D-Mark
Average 1970-1992 =100

Using Unit Labour Costs



Using GDP Deflator



17 September 1992

Chart D: Real Exchange Rate Against the French Franc
Average 1970-1992 =100