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Does the Price of the British Pound Reflect its True Value?

Katherine Calhoun
University of Northern Iowa

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by Katherine Calhoun

Introduction

The old saying "The sun never sets on the British empire," indicated an optimism on the part of the British people. It's a pity that former optimism is now missing in the British currency. Since the early 1980s, the British pound has been trading mostly on the downside with some wide swings in its value. This volatility in sterling seems to have been heightened by the 1979 discovery of oil in the North Sea, mostly because currency traders felt Britain's economy was tied to the price of oil.

Perhaps during the late 1970s and early 1980s, oil's price may have dictated the value of the British pound. According to Stevenson and Jennings (1984), the strength or weakness of the British economy is reflected in the value of the British pound. Therefore, the pound should be reflecting oil's diminished role in the economy, but it is not.

Oil's Role in the British Economy

Up to mid-1976, Great Britain was entirely dependent on imported oil, suffering the same balance of payments problems as other oil-dependent nations. Following the discovery of oil in the North Sea, however, Britain became a net exporter of oil in 1980. North Sea oil production steadily increased (as industrial nations preferred Britain's free market policy to that of OPEC) to an output of 2.6 million barrels per day in 1986. The estimated cost of production ranged from \$4 to \$8 per barrel for North Sea oil (Norman 1985).

To take advantage of the oil situation, the British government controlled the oil industry through the establishment of the British National Oil Company (BNOC), an arrangement which worked well during the high oil price years of the late 1970s and early 1980s. BNOC contributed more than \$15 billion annually to Britain's Treasury (Fleming 1984). Oil sales, royalties, and taxes comprised roughly 6 percent of the Gross Domestic Product (GDP) (Skapinker 1985).

But the bubble burst in 1984 when oil prices began to decline. The BNOC paid a fixed price for North Sea oil and then had to sell it on a declining spot oil market because it had adjusted its market prices too slowly. The BNOC lost nearly \$52 million that year (Skapinker 1985). If subsidizing the BNOC wasn't enough, the British Treasury also lost nearly 400 million pounds in revenue for each dollar drop in the price of oil (Hogg 1984).

The loss of revenue resulting from the drop in oil prices was offset by the depreciation in sterling. Sterling lost 5 cents for each one dollar decline in oil prices (Hogg 1984). Thus, the favorable exchange rate allowed Britain to continue to increase oil exports to the industrial world.

In January 1985, economists believed Great Britain could weather the decline in oil prices as long as the oil price did not drop below \$25 per barrel. If prices fell below \$25, many analysts believed the British economy would probably be devastated (Skapinker 1985).

Most currency traders agreed. Therefore, currency traders would sell sterling in reaction to the decline in the price of oil. Speculators also jumped on the selling band wagon, creating a somewhat destabilizing situation for the pound in the foreign exchange market.

The continued slide in oil prices, due to slackness in world demand and due to cheating by OPEC members on their production quotas, caused the British government to divorce itself from the oil business. In March 1985, Britain eliminated the BNOC. The British government also reduced its 32 percent stake in the British Petroleum Company and sold its North Sea acreage to Britain PLC and Enterprise Oil Company.

The Dutch Disease Phenomenon

Oil may have played a more important role in the British economy than first indicated. Oil actually caused profound structural changes in the British economy from the late 1970s to the current time which either gave rise to problems for the manufacturing sector and/or exacerbated existing problems. Economists refer to this phenomenon as the "Dutch disease."

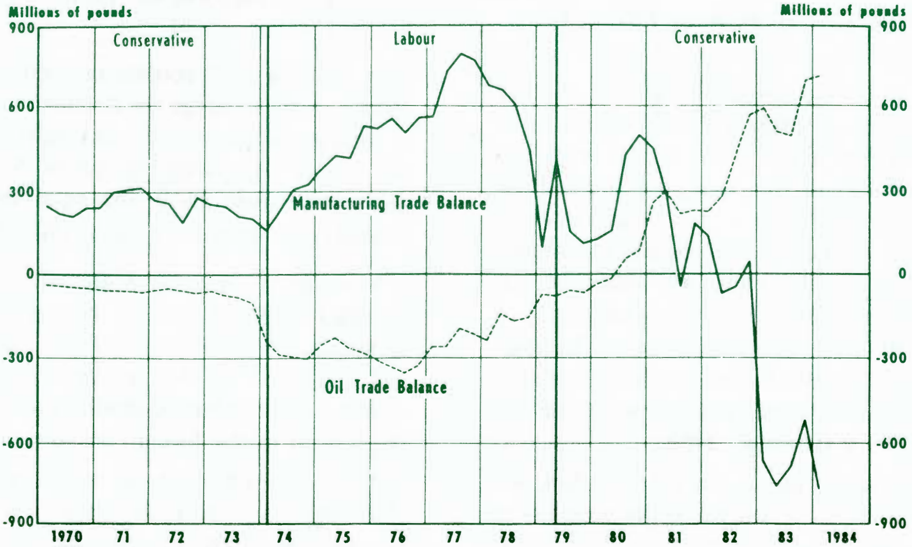
Dutch disease results from the stress placed on internal economic structures as experienced by the Netherlands during the 1970s. All industries share a pool of resources, such as labor and raw materials. If one industry grows rapidly, it bids up prices and draws the resources away from the other industries. The growing industry can afford to pass on the increased costs while the stagnant industries cannot. Therefore, stagnant industries contract to lessen costs.

"Dutch disease," and not Prime Minister Margaret Thatcher's policies, can be blamed for the high unemployment in the British manufacturing sector. Indeed, when Thatcher came to power in 1979, she departed from her predecessor's policies, and inflation fell to its lowest level since the 1960s. On the other hand, unemployment rose to its highest level since the 1930s. Job losses were borne entirely in the manufacturing sector. Manufacturing accounted for 28 percent of the workforce in 1979, and by 1982, manufacturing jobs had fallen by 1.5 million. The Manufacturing Production Index also fell from 112 in 1979 to 96 in 1983 (Chrystal 1984).

Thatcher's critics claimed this divergence was a result of the tight aggregate demand created by the restrictiveness of her monetarist policies. However, in comparing Thatcher's policies to her predecessor's, Thatcher's monetary policy was not any tighter than in previous recessions, and her predecessor's 1975-78 fiscal policy was tighter than that of

Figure 1

Oil and Manufacturing Trade Balance



Source: St. Louis Federal Reserve *Review*, May 1984, p. 29.

Thatcher's first three years in power. Therefore, this was not a valid explanation of the manufacturing sector's decline.

Others in Britain believed the world-wide recession affected the British manufacturing sector more negatively than other sectors because Britain annually exported 25 percent of its GDP (Chrystal 1984). This reasoning seemed plausible, yet Britain's manufacturing decline preceded the world recession by several months.

Therefore, Thatcher's rise to power was not the important event; it was the rise in the price of oil. The British economy went through major structural changes caused by the production of North Sea oil. These changes went into full swing as oil prices rose and as Thatcher was elected.

Although all sectors were competing for limited resources, the booming oil sector drew resources away from the manufacturing sector, pushing the cost of these resources up. While the booming oil sector could afford to pass on these extra costs, the manufacturing sector could not and was forced to lower production. Figure 1 depicts the balance of trade probelms between the oil and manufacturing sectors.

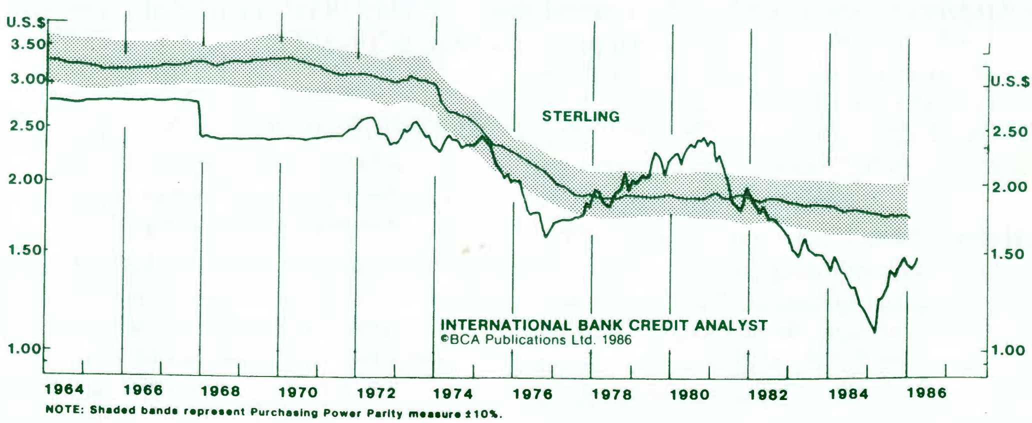
The changes in the economy produced a trade balance tipped in favor of oil. Based on the economic theory of "Dutch disease," Britain's prices rose, and the exchange rate appreciated as foreign importers demanded more pounds to pay for British oil. As the pound's value increased, the price of Britain's manufactured goods rose relative to other countries'. Notice on Figure 2, the Purchasing Power Parity (PPP) chart, that the pound's exchange rate moved higher than its PPP band would indicate. PPP did trend slightly higher during this time due to the price increases. (PPP is a short cut method of estimating the equilibrium exchange rate when a nation has a Balance of Payments problem. The exchange rate can be estimated by using a domestic price index/foreign price index ratio.)

As a result of "Dutch disease," oil exports increased at the expense of manufactured goods; therefore, the manufacturing sector became less competitive in the world market which led to its contraction. Other new oil countries exhibited this same effect.

The "Dutch disease" process could possibly be reversed. Currently, oil does not play as important a role in Britain as it previously did. The British government is continuing to divest itself of oil related businesses as oil prices are

Figure 2

Purchasing Power Parity



Source: *International Bank Credit Analyst*, April 1986, p. 19.

declining. Perhaps underlying the deemphasis on the oil sector is the prediction that Britain will run out of oil by the end of the century and the realization that manufacturing must improve to compensate for the lack of oil revenue.

British manufacturers are again becoming competitive, with the exchange rates somewhat depressed and the oil sector losing steam. During 1985, real rates of return in the nonoil British sector returned to the levels of the 1960s, and profits rose 21 percent.

Other Factors Affecting Sterling's Value

Other factors besides the "Dutch disease" phenomenon and the dominance of oil in the British economy also affected the value of the pound.

Currency traders' perceptions

Most analysts believe that prices of oil and the pound move directly together. Then why did the British pound move lower as the price of oil rose during the early 1980s and begin to recover as the price of oil fell to around $11 per barrel?

The pound bottomed near $1.03 in January-March 1985, about the time the British government eliminated the BNOC. Some currency specialists confirmed that without the drain of the BNOC on the British Treasury, the government could begin stimulating the economy. Sterling then began to move higher.

Probably the most important factor explaining the discrepancy between crude's fall and the pound's rise was the turnaround in the value of the U.S. dollar. The Group of Five (G-5)[1] industrial nations meeting in late September 1985 effectively weakened the value of the dollar and shifted currency traders' attention to the other major currencies. Since then, the British pound has appreciated; however, the pound has lagged its other major currency counterparts. One reason for this lag is that sterling has not completely shaken off the fluctuations in the oil market. Since the continued decline in the price of oil undermined favorable sentiment towards sterling, traders shifted their money to the currencies showing the best potential for gains. Table 1 shows the appreciation of the four major currency futures and the depreciation in oil.

Going into the first high in December 1985, the British pound held up relatively well against the other currencies, but it was then left behind. As other currencies rose in value into 1986, the British pound actually fell 8.5 percent compared to the other currencies as

Table 1

Appreciation of Major Currencies and the Depreciation of Oil from the G-5 Meeting to March 1986

Appreciation (depreciation) from:

	G-5 meeting to 1st high	G-5 to 1986 high
June Swiss franc	14.5%	27%
June Japanese yen	11.0	28
June Deutschemark	12.8	27
June British pound	9.0	12
Crude oil	(38.5)	(57.7)

Source: Commodity Price Charts, March 28, 1986, and author's calculations a result of plummeting crude oil prices. However, recent favorable remarks about the British economy and a tax cut in the face of falling crude prices have changed the perceptions of some currency traders. These traders have bought the British pound because they believe sterling is now undervalued.

Fiscal policy

As oil prices continued falling to $15 a barrel in early 1986, the British Treasury lost 5 billion pounds of expected oil revenue (*International Bank Credit Analyst* 1986). Most British government officials believe the oil price, now around $11 a barrel, will come back to settle near $15 per barrel. Even at that price, few international analysts felt Britain could afford to cut taxes and contain government borrowing.

But on March 18, 1986, Britain did just that. The Chancellor of the Exchequer, Nigel Lawson, surprised the world and offered 1 billion pounds in income tax cuts to the public with the expectation that government borrowing would be kept to less than 2 percent of GDP (Norman 1986). The British government could slash taxes because of the following four financial factors: public expenditure growth had slowed; the economic expansion had caused nonoil tax revenues to be above expectations; privatization of state industries brought in almost double the previous year's revenue; and nationalized industries' financial needs fell in the last five years (*International Bank Credit Analyst* 1986). This meant that the British government could survive without the 5 billion pounds of lost oil revenue.

Even though oil makes up 6 percent of Britain's economic output, the benefits of cheaper oil to the other 94 percent of Britain's GDP should offset the drop in oil revenues to the Treasury. Chancellor Lawson hoped that as nonoil corporate profits rose, so would consumer spending and economic activity. Therefore, he could cut taxes without increasing the budget deficit.

Monetary policy

British interest rates had fallen in conjunction with the other industrial nations.' Long term bonds were around 9 percent during 1986 and short term rates fell to 11.5 percent.

One problem Britain has had is the growth of its money supply. Its broad money measure was targeted to grow at 5 percent to 9 percent during 1985, but it actually grew at 14.5 percent. Lawson believed the money supply growth was due to the growth in private lending, the Bank of England paying some of its debts, and the attractiveness of high interest money deposits. The 1986 target was 11 to 15 percent with currency traders believing that the British government would not hike interest rates to slow money growth (*International Bank Credit Analyst* 1986).

To keep inflation in check with the easier monetary policy, Lawson had modest targets in mind for narrow money growth, a falling rate of growth of money GDP, and planned to hold exchange rates higher by keeping interest rates high.

Capital inflows

Britain had maintained high interest rates to squeeze out inflation and maintain the exchange rate. Britain's interest rates had been some of the highest of the industrial nations during 1986. The British base lending rate, which is like the U.S. discount rate, was pegged at 11 percent, and inflation in Britain was expected to range from 3 to 5 percent for 1986 (Norman 1986). This left investors with a real rate of return of 6 to 8 percent. The U.S., which had held the best real rate of return, offered only about a 3.5 percent return on investors' money during early 1986. Eurosterling offered returns of up to four percentage points more than Eurodollars.

The higher British rate of return, plus the better economic news, is allowing capital to flow into Great Britain. As economic theory suggests, capital flows to the area with the highest rate of return. This inflow creates an increse in the demand for British securities and an increase in demand for sterling. If the supply of sterling remains unchanged and demand rises, the exchange rate appreciates. Currency traders maintained in April 1986 that even if Great Britain dropped rates another 1.5 percent, a favorable interest rate differential would still exist. Hence, the pound has been favored on downsticks in crude oil, according to several currency traders on the International Monetary Market in Chicago.

Loss in comparative advantage

Britain apparently has lost its comparative advantage in the production of many products such as coal, steel, shipbuilding, textiles, cars, trucks, and telecommunications.

Why has Britain lost that advantage? The explanation rests with "English disease"—the unwillingness to change.

English disease has been around for decades and its roots are in the class system of Britain. This class system incorporates these ideas:

> *a generational decrease in entrepreneurial spirit; social prejudices against manufacturing and trade with a bias favoring liberal over technical education; failure to apply science and technology to trade; concentration on traditional and easy, but slower growing markets; complacent management and obstructive trade unions; industrial relations poisoned by class discrimination and resistance to change all around.* (Jenkins 1985)

The widespread incorporation of these beliefs throughout Britain has rendered Britain uncompetitive with the rest of the world. Even though the "Dutch disease" explanation of the shifting of resources from British manufacturing to the North Sea oil sector explains much of the decline in the manufacturing sector, the impact of these long term inefficiencies in quality of British management, working practices, product design, and training and education cannot be ignored (Jenkins 1985). The boon of North Sea oil only seemed to mask these inherent weaknesses in the British economy.

Margaret Thatcher was the first politician to recognize and address the issue of "English disease."

> *Margaret Thatcher dreams of Britain becoming an enterprise society on the American model, but we aren't the U.S. and never can be. We are a small, homogenous island society with a long and heavy past.* (Jenkins 1985)

Britain's decline took place over decades and cannot be changed overnight. However, attitudes are changing, and some evidence exists that Britain is attempting to arrest the "English disease." Thatcher has shaken up many facets of British life during the 1980s. The hold of trade unions on the British economy is weakening, and a change in attitudes toward the unions' role in society is occurring. The recent recession and the development of new technology has hastened attitude changes toward the unions and toward liberal arts education.

As a result of these changes toward a more liberalized economy, Britain has become one of the fastest growing economies in Europe. The nationwide productivity rate is rising faster than at any time since World War II; company profits have increased 20 percent a year; and per capita income growth has topped most industrial nations' rankings. Inflation remains low, around 3 to 5 percent, and industrial investment is at a peak. Additionally, business starts are at a record (Brady 1985). All of these facts provided further evidence for confidence in the British pound.

Conclusion

Where does this leave the value of the pound?

As it became an important industry, oil caused some distortions in the structure of the British economy. The oil sector gained at the expense of other sectors, most notably the manufacturing sector. This created an overvalued exchange rate.

The current evidence on stimulative monetary and fiscal measures for the British economy, its attempt to regain its comparative advantage, and the inflow of capital, suggest that the British pound is undervalued, primarily due to oil's influence. Even though oil should not be given that much consideration in the British economy, changing currency traders' minds is difficult. Sterling is trading below its PPP band. Since the exchange rate should reflect a nation's PPP, the pound needs to rise. Sterling should be able to move to its recent historical level, around $2 per pound, which reflects its true value. As of April 1987, the British pound was at $1.65.

Note

[1] The G-5 are the Treasury Secretaries from the five leading industrial nations who periodically meet to discuss exchange rate stability. The five industrial nations include the U.S., Great Britain, France, West Germany, and Japan.

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