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Sterling depreciation & the UK trade balance.

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In this brief the Sheffield Political Economy Research Institute (SPERI) considers the relationship between the relative value of sterling and the UK trade balance. When a country's currency depreciates in value relative to its major competitors, its exports become cheaper (and imports become more expensive). The depreciation of sterling experienced in the wake of the financial crisis should therefore have boosted policy-makers' efforts to rebalance the economy towards exports and away from the domestic consumption of imported goods.

Background

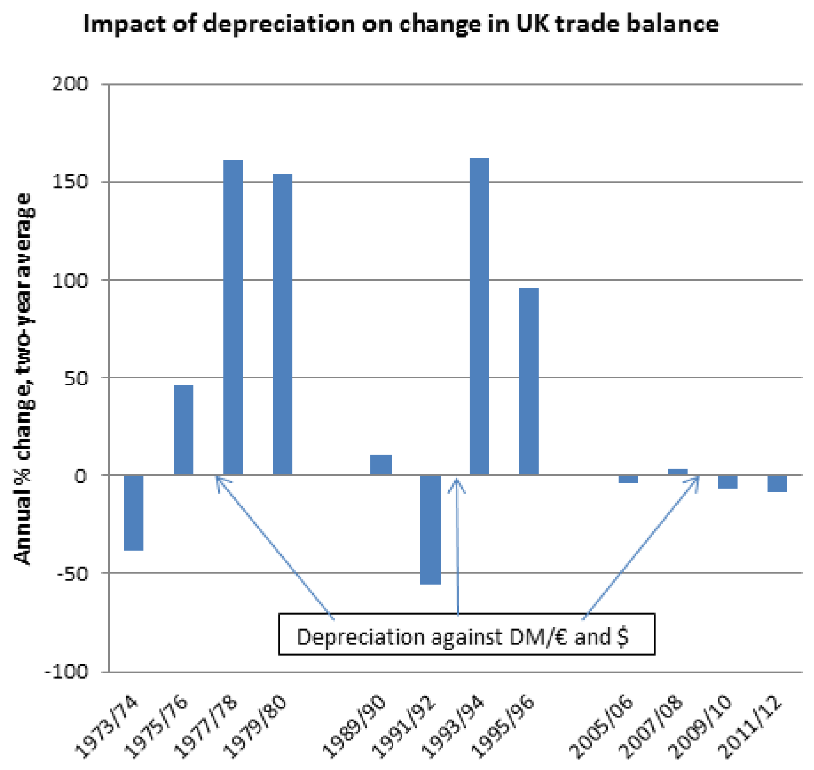
- Other things being equal, a country's exports become more attractive to overseas firms and consumers when its currency depreciates in value. It also becomes more expensive to import goods from overseas.
- Although depreciation rarely occurs in ideal economic circumstances, more exports and fewer imports result in an improved trade balance, traditionally seen as a key barometer for the health of an economy.
- Since the 1970s there have been three significant periods of sterling depreciation: in 1976 (in advance of the so-called IMF crisis), in 1992 (after the UK withdrew from the European Exchange Rate Mechanism), and amid the financial crisis of 2008.
- Although direct devaluation of currencies is impossible when exchange rates are floating, the Bank of England's policy of quantitative easing is partially designed to boost the economy by enabling sterling depreciation.
- There is evidence of 'competitive devaluation' among Western economies since the financial crisis – but central control of monetary policy in the Eurozone has handicapped many European countries in this regard.
- The UK coalition government has made the boosting of exports a key pillar of its efforts to rebalance the economy away from domestic consumption – sterling depreciation should assist this agenda, at least temporarily.
- After the United States, the UK's main trading partners are its European neighbours. Traditionally, the UK exported more to Commonwealth and Anglosphere countries than to Europe, but the creation of the European single market and the growing reliance of the UK on exporting financial and business services have contributed to the 'Europeanisation' of the UK's export base.
- European competitors, most notably Germany, have re-oriented their exports towards emerging economies such as China.

Evidence

- In 1976, sterling fell by 25 per cent against the deutschemark and 19.2 per cent against the dollar. In the following two years, the UK trade balance improved by an annual average of 161 per cent, followed by an annual average of 153 per cent for the subsequent two years.
- These changes in the trade balance represented a significant improvement on the trend evident in the four years prior to depreciation.
- In 1992, sterling fell by 15.3 per cent against the deutschemark and 10.9 per cent against the dollar. In the following two years, the UK trade balance improved by an annual average of 162 per cent, followed by an annual average of 96 per cent for the subsequent two years.
- These changes in the trade balance represented significant improvements on the trend

evident in the four years prior to depreciation.

- In 2008, sterling fell by 15.4 per cent against the euro and 24.4 per cent against the dollar. However, the UK trade balance deteriorated by an annual average of 6 per cent in the following two years, followed by an annual average of 8 per cent for the subsequent two years.
- The UK's significant trade deficit remained largely unchanged throughout the period 2005-12, despite depreciation in 2008.
- At the end of 2013, sterling was still 15.8 per cent down against the euro and 20.9 per cent down against the dollar, compared to its value at the end of 2007. Yet the UK still carries a trade deficit of almost £30 billion.



See annex for sources

Analysis

- Unlike previous episodes of sterling depreciation, the UK economy has not been able to take advantage of the recent fall in the value of the pound to achieve an improved trade balance.
- The financial crisis and its aftermath represent a unique set of economic circumstances. However, sterling depreciation in both 1976 and 1992 occurred in poor economic conditions, and yet in both periods the trade balance improved significantly as a result.
- The persistence of a large trade deficit, despite depreciation in 2008, calls into question the basis of the government's policy of quantitative easing. The policy has redistributed wealth to the most affluent members of society, yet has seemingly not delivered the promised economic boost.

- The evidence presented here adds weight to the argument that the UK economy has deep-rooted problems. Sterling depreciation should have resulted in more exports and fewer imports, to a much greater extent than is evident.
- The coalition government promised to increase UK exports, but has failed to rebalance the economy towards highly tradable sectors, such as manufacturing, and to reorient exports towards emerging economies, such as China.
- The ongoing economic problems in the Eurozone are partly responsible for the UK's failure to improve its trade balance. However, this demonstrates the danger of relying excessively on exporting financial and business services exports to European economies, and the consequent potential benefit of establishing a more diversified export base.

Conclusion

Sterling depreciated significantly following the financial crisis, and its value has remained low against the euro and the dollar for several years. Yet, unlike previous episodes of depreciation, this has not resulted in an improved trade balance. Depreciation – which has in part been brought about by the quantitative easing programme – represented the ideal opportunity for the UK economy to be rebalanced towards exports and away from domestic consumption. It seems, however, that the UK's deep-rooted economic problems have prevented any such transformation.

Annex 1

Sterling value against the Deutschemark/Euro and the Dollar, selected years

	Quarterly average spot exchange rate, Deutschemark/ Euro into Sterling	% change, fourth quarter to fourth quarter	Quarterly average spot exchange rate, Dollar into Sterling	% change, fourth quarter to fourth quarter
Q4 1975	5.3031		2.0431	
Q4 1976	3.9764	-25.0	1.6508	-19.2
Q4 1991	2.8849		1.7733	
Q4 1992	2.4449	-15.3	1.5808	-10.9
Q4 2007	1.4129		2.0456	
Q4 2008	1.1957	15.4	1.5742	-24.4
		% change, fourth quarter 2007 to fourth quarter 2013		% change, fourth quarter 2007 to fourth quarter 2013
Q4 2013	1.189	-15.8	1.6185	-20.9

Source: Bank of England

Annex 2

Sterling value against the Deutschemark/Euro and the Dollar, selected years

	Trade balance (£million)	Annual % change, two-year average
1973	-1666	
1974	-3949	-38
1975	-1537	
1976	-1058	46
1977	1433	
1978	2681	161
1979	1247	
1980	5743	153
1989	-17181	
1990	-9828	10
1991	-1117	
1992	-3344	-55
1993	-980	
1994	1506	162
1995	4172	
1996	3527	96
2005	-35580	
2006	-35199	-3
2007	-36733	
2008	-32572	3
2009	-23373	
2010	-32852	-6
2011	-23260	
2012	-33901	-8
2013*	-28832	

**annualised rate based on Q1-Q3*

Source: ONS

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