

**ECONOMICS:** EUROPEAN PERSPECTIVES—AUGUST 20, 2010

# Is the Pound Cheap Enough to Rebalance the UK's Economic Growth Drivers?

■ **Darren Williams**  
 Senior European Economist—Global Economic Research

There is little doubt that the UK economy needs to shift away from its traditional growth drivers. But this process is likely to be complicated by structural weaknesses in the manufacturing and export sectors. Nor is it clear that the pound is weak enough to foster a painless rebalancing process.

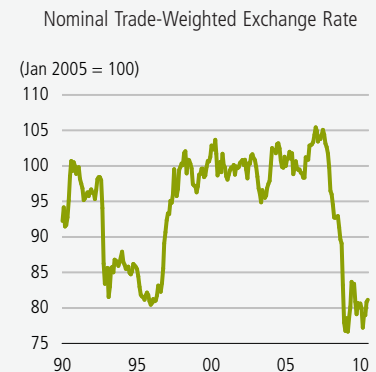
At the Bank of England's latest press conference, Governor Mervyn King argued that the economy needs to rebalance away from domestically generated, service-led growth towards manufacturing and exports. With tight credit conditions, financial de-leveraging and fiscal restraint likely to weigh on the UK's traditional growth drivers—consumption and housing—we believe such a transition is essential if the UK is to sustain underlying growth rates close to the historical norm. But how achievable is this rebalancing?

One factor that should help the economy rebalance is the exchange rate. Although the pound has risen slightly over the last year, its trade-weighted exchange rate is still 20% lower than it was on average between 1997 and 2007 (**Display 1**). This is important, as there is compelling evidence to suggest that the pound was grossly overvalued during this period. Indeed, manufacturing output stagnated between 1997 and 2007, while the UK's export performance deteriorated at an alarming pace (**Display 2**).

Helped by strong world-trade growth, the weaker pound is already having a positive impact. In the second quarter, for example, exports were 15.5% higher than they were a year earlier. This, in turn, provided the main impetus for a 3.8% year-on-year gain in manufacturing output. The latter may not sound impressive when compared with Germany, where manufacturing production was up 13.4% in the second quarter, but it is the highest year-on-year growth rate recorded by the UK manufacturing sector since the fourth quarter of 1994.

While a weaker exchange rate should help the UK rebalance, we see three potential hurdles. The first relates to the geographical structure of exports. Specifically, UK trade is dominated by exports to other developed countries, particularly the slow-growing euro area (49% of total exports). Last year, just 20% of UK exports went to emerging nations. This is far lower than for the euro area or the US, where exports to emerging markets accounted for almost 50% of external shipments.

Display 1  
The Pound's Dramatic Decline



Source: Haver Analytics and AllianceBernstein

Display 2  
Exports Have Underperformed



Actual export growth less export-market growth  
 Source: Haver Analytics, OECD and AllianceBernstein

Put differently, International Monetary Fund (IMF) data show that exports to emerging countries accounted for 3.3% of UK Gross Domestic Product (GDP) in 2009 **(Display 3)**. Euro-area exports to emerging markets were much higher than this, at 6.9% of GDP, with Germany even higher, at 9.6%. The UK is not well placed to benefit from strong emerging-market demand growth.

The second problem relates to the size of the manufacturing sector (or rather the lack of it). In recent years, manufacturing has declined as a share of output in most developed countries. But this process has been particularly acute in the UK, and manufacturing now accounts for less than 12% of total output. One consequence of this is that manufacturing must grow very strongly in order to have a meaningful impact on economic growth. Another is that the sector may be too small to meet a significant increase in external demand, at least in the near term.

Of course, the declining importance of UK manufacturing needs to be seen in the context of sterling's extreme overvaluation between 1997 and 2007—a period in which the sector's decline accelerated visibly, particularly in contrast to Germany **(Display 4)**. Hence, it is reasonable to assume that a more competitive exchange rate will allow manufacturing to recover. But this will require a significant shift of resources towards export-sensitive sectors, and this is unlikely to happen quickly.

This brings us to the final potential hurdle: is the pound cheap enough to allow a rapid rebalancing of the economy? This may seem like a strange question given sterling's recent decline. However, in real terms and over longer horizons, the pound does not look particularly cheap **(Display 5)**. Indeed, the recent decline has simply corrected the extreme overvaluation

seen between 1997 and 2007. As a result, the real exchange rate is currently just 5% lower than it was in the second quarter of 1992, shortly before the UK abandoned the European Exchange Rate Mechanism. At that time, the pound was widely regarded as being heavily overvalued.

In real terms, the pound is also significantly higher than it was in the 1970s, before the discovery of North Sea oil drove it skyward. In this respect, it may be worth noting that the UK's current account position was, on average, close to balance in the 1970s. Since the early 1980s, by contrast, the UK has run a large structural current account deficit.

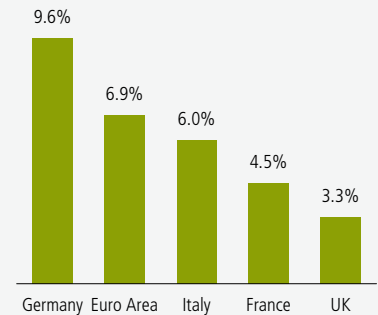
Establishing fair value for exchange rates is not a precise science. A useful benchmark may be the period between 1980 and 1995 when UK exports, on average, moved broadly in line with export-market growth. Interestingly, the average real exchange rate during that period is almost identical to the average over the last four decades. Either metric would suggest that the pound is currently slightly overvalued.

Given the magnitude of sterling's decline since the middle of 2007, it is tempting to think that the adjustment is now complete—or even that the exchange rate has overshot. But there is ample evidence to suggest that this may not be the case and that a further decline may be needed to help the economy rebalance.

But, how will this be achieved? With the US also seeking to rebalance and the euro area requiring a weaker exchange rate to offset fiscal tightening in the periphery, most of the developed world seems to need a weaker exchange rate. With this in mind, we believe there is a risk that the pound may remain too strong to allow a painless rebalancing of the UK economy. ■

Display 3  
Low Exposure to Emerging Market Growth

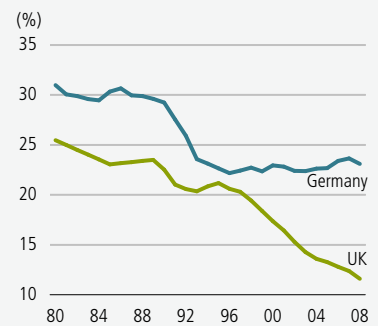
Exports to Emerging Economies as a Share of GDP



Source: Haver Analytics, IMF and AllianceBernstein

Display 4  
Manufacturing Has Fallen in Importance

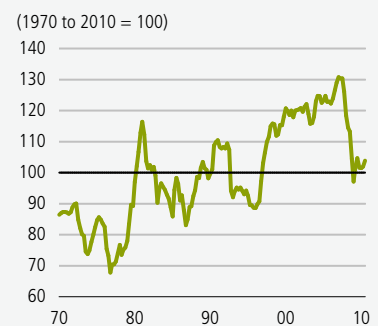
Manufacturing Share of Total Output



Source: Haver Analytics and AllianceBernstein

Display 5  
How Cheap Is the Pound?

Real Exchange Rate Deflated by Manufacturing Unit Labor Costs



Source: European Commission, Haver Analytics and AllianceBernstein

---

The information contained here reflects the views of AllianceBernstein L.P. or its affiliates and sources it believes are reliable as of the date of this publication. AllianceBernstein L.P. makes no representations or warranties concerning the accuracy of any data. There is no guarantee that any projection, forecast or opinion in this material will be realized. Past performance does not guarantee future results. The views expressed here may change at any time after the date of this publication. This document is for informational purposes only and does not constitute investment advice. AllianceBernstein L.P. does not provide tax, legal or accounting advice. It does not take an investor's personal investment objectives or financial situation into account; investors should discuss their individual circumstances with appropriate professionals before making any decisions. This information should not be construed as sales or marketing material or an offer of solicitation for the purchase or sale of, any financial instrument, product or service sponsored by AllianceBernstein or its affiliates.

**Note to Canadian Readers:** AllianceBernstein provides its investment management services in Canada through its affiliates Sanford C. Bernstein & Co., LLC and AllianceBernstein Canada, Inc.

**Note to UK Readers:** UK readers should note that this document has been issued by AllianceBernstein Limited, which is authorised and regulated in the UK by the Financial Services Authority. The registered office of the firm is: Devonshire House, One Mayfair Place, London W1J 8AJ.

**Note to Australian and New Zealand Readers:** This document has been issued by AllianceBernstein Australia Limited (ABN 53 095 022 718 and AFSL 230698). Information in this document is intended for wholesale investors only, and is not to be construed as advice.

**Note to Readers in Vietnam, the Philippines, Brunei, Thailand, Indonesia and India:** This document is provided solely for the informational purposes of institutional investors and is not investment advice, nor is it intended to be an offer or solicitation, and does not pertain to the specific investment objectives, financial situation or particular needs of any person to whom it is sent. This document is not an advertisement and is not intended for public use or additional distribution. AllianceBernstein is not licensed to, and does not purport to, conduct any business or offer any services in any of the above countries.

**Note to Readers in Malaysia:** Nothing in this document should be construed as an invitation or offer to subscribe to or purchase any securities, nor is it an offering of fund management services, advice, analysis or a report concerning securities. AllianceBernstein is not licensed to, and does not purport to, conduct any business or offer any services in Malaysia. Without prejudice to the generality of the foregoing, AllianceBernstein does not hold a capital markets services license under the Capital Markets & Services Act 2007 of Malaysia, and does not, nor does it purport to, deal in securities, trade in futures contracts, manage funds, offer corporate finance or investment advice, or provide financial planning services in Malaysia.

**Note to Singapore Readers:** This document has been issued by AllianceBernstein (Singapore) Ltd. (Company Registration No. 199703364C). The Company is a holder of a Capital Markets Services Licence issued by the Monetary Authority of Singapore to conduct regulated activity in fund management.

**Note to Taiwan Readers:** This information is provided by AllianceBernstein funds Taiwan Master Agent, AllianceBernstein Taiwan Limited. SFB operating license No.: (97) FSC SICE no. 049. Address: 57F-1, 7 Xin Yi Road, Sec. 5, Taipei 110, Taiwan R.O.C. Telephone: 02-8758-3888. AllianceBernstein Taiwan Limited is a separate entity an independently operated business.

**Note to Hong Kong Readers:** The document has not been reviewed by the Hong Kong Securities and Futures Commission. The issuer of this document is AllianceBernstein Hong Kong Limited.