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January 31, 1984

To: Members of the Executive Board

From: The Secretary

Subject: United Kingdom - Staff Report for the 1983 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1983 Article IV consultation with the United Kingdom, which has been tentatively scheduled for discussion on Monday, February 27, 1984.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Mr. Owen Evans (ext. (5)8793) or Ms. Padma Gotur (ext. (5)8797).

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INTERNATIONAL MONETARY FUND

UNITED KINGDOM

Staff Report for the 1983 Article IV Consultation

Prepared by the Staff Representatives for the
1983 Consultation with the United Kingdom

Approved by L. A. Whittome and W. A. Beveridge

January 31, 1984

I. Introduction

A staff team consisting of Messrs. de Fontenay (EUR), Vittas (EUR), Otani (ASD), Evans (EUR), Ms. Gotur (EP, EUR), and Mrs. Girvan (EUR), as secretary, held Article IV consultation discussions in London from December 1 to 12, 1983. The U.K. representatives included officials of the Treasury, the Departments of Employment, Energy, and Trade and Industry, the Central Statistical Office, and the Bank of England. Messrs. de Fontenay and Vittas also met with the Chancellor of the Exchequer, the Rt. Hon. Nigel Lawson, the Financial Secretary, Mr. John Moore, and the Governor of the Bank of England, Mr. Robin Leigh-Pemberton. Mr. Nigel Wicks, Executive Director for the United Kingdom, attended the meetings as an observer. The United Kingdom formally accepted the obligations of Article VIII, Section 2, 3, and 4, as of February 15, 1961.

II. Report on the Discussions

1. Economic policy in recent years

The Government which took office in March 1979 sought to secure the necessary conditions for a revival of private sector activity. These conditions included a winding down of inflation, the reduction of the role of Government in the economy, and the removal of distortions and rigidities in labor and goods markets, as well as in the financial system. At the basis of the Government's strategy was the conviction that the poor performance of the British economy had not been due to a shortage of demand but to a failure of response on the supply side. The new policy implied a move away from short-term demand management and from state intervention. Its main thrust has been maintained since 1979 and, in particular, after the June 1983 election, although the emphasis on certain parts of the program has changed and implementation has varied in intensity.

Monetary policy was given the main responsibility for reducing inflation and, in order to avoid excessive pressures on interest rates, lower money growth was to be supported by lower levels of the public sector borrowing requirement (PSBR). The Government's program also included cuts in public spending and in direct taxes. The shift of financial policies toward restraint had actually begun in 1975-76 when cash limits on government expenditure and monetary targets were introduced. But whereas these initiatives were mainly taken in response to balance of payments difficulties, the new Government's financial policies were aimed more broadly at improving the performance of the economy. The other innovation was the introduction in the March 1980 budget of a medium-term financial strategy (MTFS) which was designed to provide a clear indication of the direction of policies and to shift attention away from short-term demand management to fundamental structural issues.

In its early stages, the implementation of the Government's financial policies encountered severe obstacles, including the world recession. The shift from direct to indirect taxation, higher energy prices and public enterprise charges, and large increases in public sector salaries following the recommendations of a Commission on Pay Comparability, pushed the rates of earning and price increases above 20 percent in the first months of 1980. Thereafter, the fight against inflation received a higher priority and the adjustment effort became commensurately more severe, as exemplified by the tough budget presented in March 1981. The emergence of the United Kingdom as a major oil producer after 1979 had also a powerful influence on economic developments during that period. The development of North Sea oil raised national income and improved the trade balance, but also reinforced the upward pressure on the exchange rate resulting from the tightening of monetary policy. Between 1978/1 and 1981/1, 1/ the real effective exchange rate of the pound sterling, measured by relative normalized unit labor costs, appreciated by 63 percent.

Largely on account of the difficulties encountered in the early stages, the implementation of financial policies had to be more flexible than originally envisaged. Although monetary growth was allowed to exceed the target by a wide margin from 1979 to 1982, the behavior of interest rates, the exchange rate, and inflation suggested that monetary conditions were in fact tight. In 1982, target ranges for M1 and PSL2 (a broad measure of liquidity) were introduced in addition to that for sterling M3 which was raised. It was only in 1983 that both the monetary targets and the actual rise in sterling M3 declined to the 7-11 percent range initially set for 1979-80.

Notwithstanding the recession and the rise in unemployment, the authorities succeeded in reducing the PSBR, though at a slower pace than initially envisaged. For FY 1983/84, the PSBR is estimated to be equivalent to 3.3 percent of GDP compared with 4.9 percent in 1979/80 and

1/ First quarter of 1978 and first quarter of 1981. The same notation is used throughout the report.

5.7 percent in 1980/81. North Sea oil revenue and sales of public assets accounted for the greater part of this improvement, namely, the equivalent of 1.5 percent of GDP between 1980/81 and 1983/84. The Government also aimed at reducing the share of both public expenditure and taxes in GDP, but it did not reach its goal. The surge in expenditure in 1979 and 1980 resulting from public sector pay settlements and the steep rise in unemployment as the recession took hold together with the commitment to higher defense spending, and the cost of the Falkland military operations made the goal of reducing the ratio of public expenditure to GDP all the harder to reach. In addition, the previous government had already trimmed a number of spending programs. Total expenditure of general government is estimated at 45 1/2 percent of GDP in 1983/84, compared with less than 44 percent in 1979/80 (but a peak of 47 percent in 1981/82). Within this total, capital expenditure, particularly for housing, has fallen in real terms. As the goal of reducing the PSBR as a proportion of GDP was given a higher priority than that of lowering the tax burden, in order to avoid a rise in interest rates, the upward trend of public expenditure has entailed a significant increase in the overall tax burden. Thus, despite the shift from direct to indirect taxes in 1979, the income tax burden has risen, partly due to the discretionary increases in personal taxes in the 1981 budget.

While financial policies were bearing down on inflation, the Government has been taking a number of measures on the supply side. These have included the removal of controls over wages and prices, capital movements, investment location, bank operations, and, soon, over the stock exchange; the sale to the private sector of a growing number of public enterprises; the extension of incentives to small businesses and high-technology firms; and labor legislation designed to reduce rigidities in the labor market by correcting what was viewed as the excessive power of trade unions in industrial relations (see the recent economic developments paper).

2. The results

The relative performance of the British economy in recent years is summarized in Charts 1 and 2. The record cannot, of course, be attributed entirely to the policies followed. As already mentioned, a number of exogenous factors, such as oil and commodity prices and foreign demand, have played an important role. In the early stages of the Government's fight against inflation, interest rates reacted more quickly than output and prices to monetary tightening, as is usually the case. Together with the effect of North Sea oil, this resulted in a substantial real appreciation of sterling which had a favorable effect on prices but put a tight squeeze on the traded goods sector, particularly manufacturing. Subsequently, the lowering of interest rates resulting from the progress in reducing domestic inflation and public sector borrowing, combined with the weakening of the oil market, reversed part of the real appreciation experienced between 1979 and 1981. The loss of output and employment associated with the winding down of inflation was also greater than expected owing to the resilience of inflationary expectations and the stubborn rigidity of real wages.

What the standard indicators of performance cannot measure is the extent to which the climate for business activity has improved and the foundations for sound noninflationary growth in the years ahead have been laid as a result of the structural changes brought about by the Government's policies. It is probably too early to come to a conclusion on this but there is some evidence, such as the soaring share prices and the substantially higher rate of productivity growth, to support the Government's claim that underlying conditions have indeed improved. The rest of this section focuses on the current economic recovery, on the policies which have led to it, and on the improvement in business conditions.

a. The recovery

The United Kingdom emerged from the recession earlier than other countries. The cyclical trough was reached in 1981/2 and from then to 1983/3 GDP had grown by 6.1 percent (Chart 3). 1/ So far the recovery has been comparable in strength to that of 1975-79 (Chart 4) and, on both occasions, stockbuilding and consumer spending have provided the main stimuli to demand (Tables 1 and 2). In contrast to the previous recovery,

Table 1. United Kingdom: Contributions to Changes in Real GDP

(In percent of real GDP, seasonally adjusted actual rates)

	1980	1981	1982 1st half	1982 2nd half	1983 1st half
Private consumption	-0.3	0.1	0.1	1.7	0.7
Public consumption	0.3	--	--	0.2	0.5
Fixed investment	-0.9	-1.6	0.7	0.5	0.3
Stockbuilding	-2.5	-0.2	-0.1	-1.9	1.5
Domestic demand	-3.4	-1.8	0.7	0.5	3.0
Exports	--	-0.6	--	-0.3	0.1
Imports	-0.9	-0.6	-0.2	-0.9	1.3
GDP (average measure)	-2.5	-1.7	0.9	1.1	1.8

Source: CSO, *Economic Trends*.

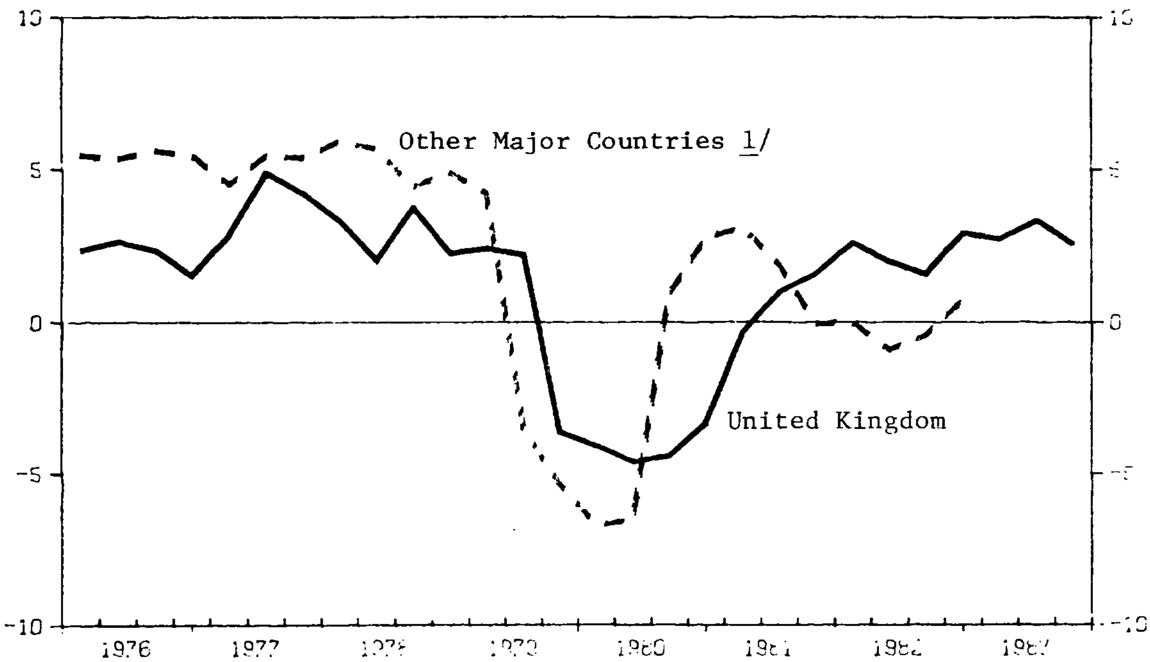
1/ Based on an average of output, income, and expenditure measures of GDP, which at times diverge by a significant margin.

CHART 1

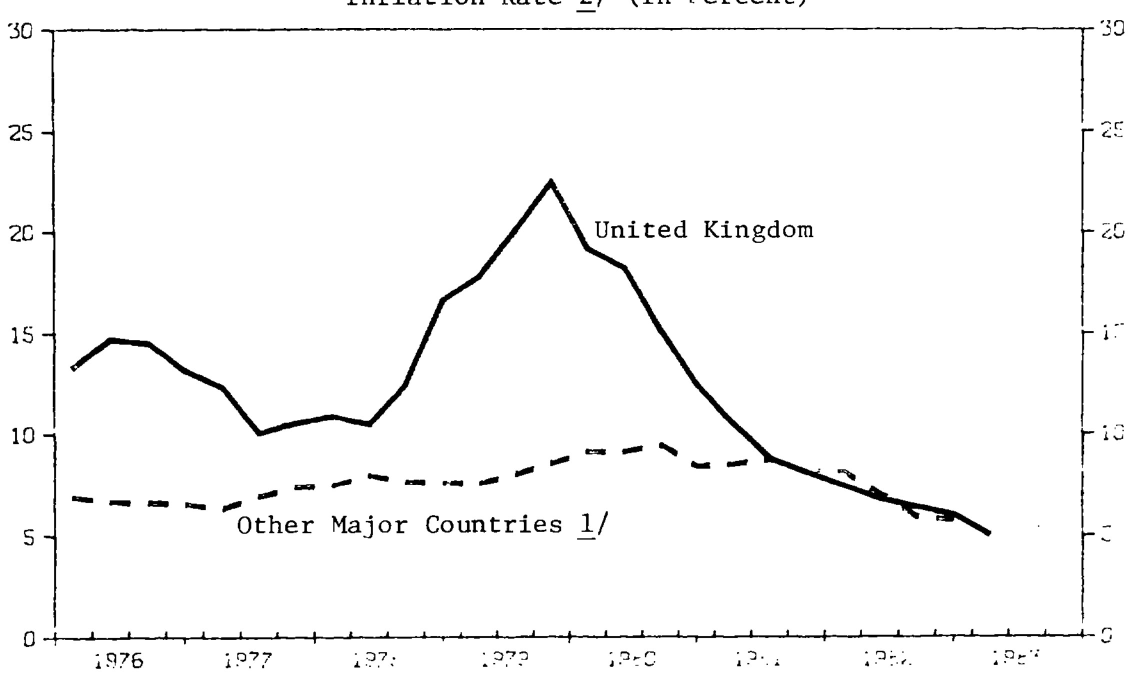
UNITED KINGDOM

OUTPUT AND INFLATION IN AN INTERNATIONAL CONTEXT

Rate of Growth of Real GDP (Annual Percentage Change)



Inflation Rate 2/ (In Percent)



Sources: IMF, Datafund; data supplied by the U.K. authorities; and staff estimates.

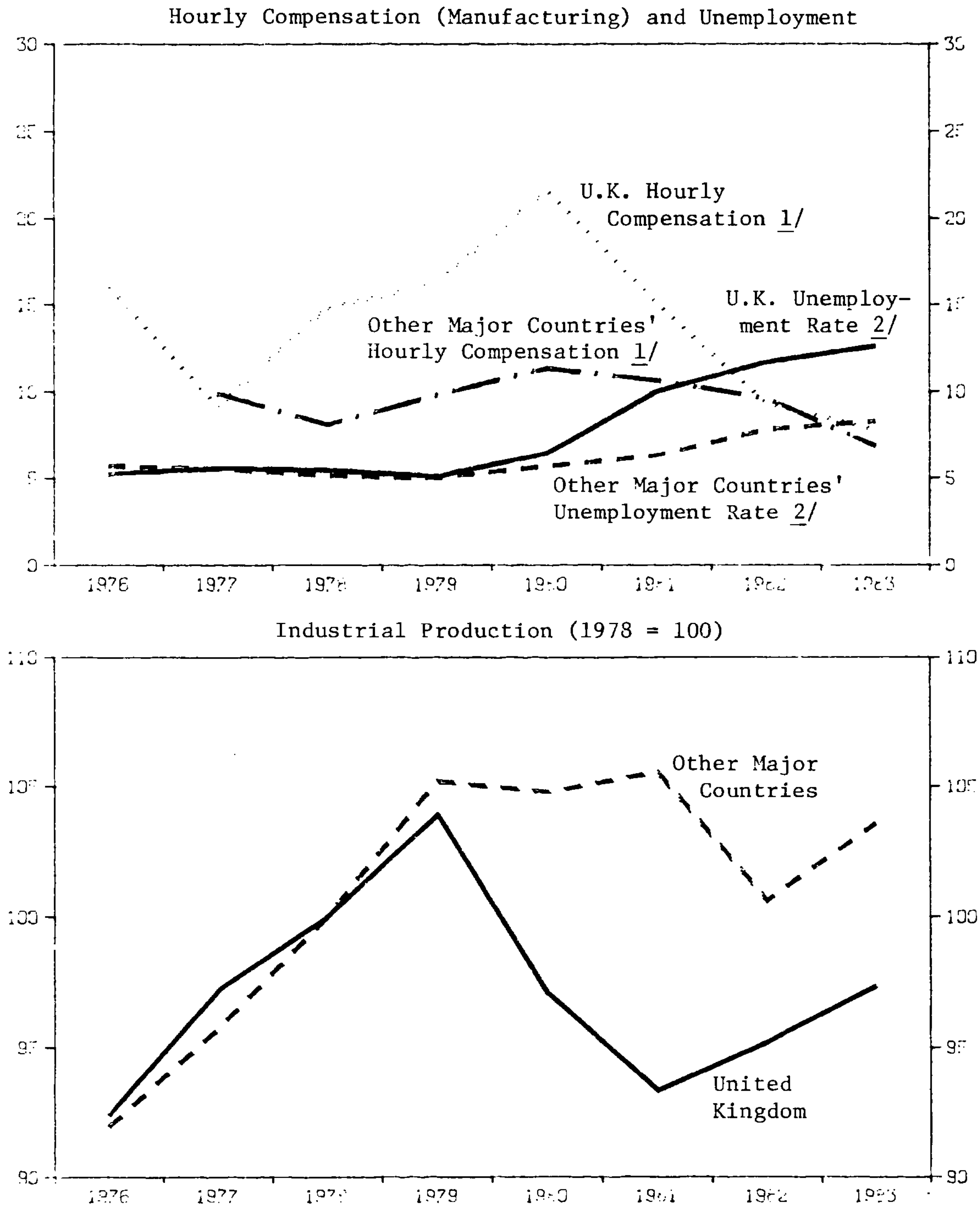
1/ Weighted average (1980 GDP weights) for the seven major countries (except United Kingdom).

2/ GDP deflator.

CHART 2

UNITED KINGDOM

WAGES, UNEMPLOYMENT, AND PRODUCTION



Sources: IMF, Datafund; data supplied by the U.K. authorities; and staff estimates.

1/ Annual percentage change in manufacturing. 1980 GDP weights for seven major countries excluding United Kingdom.

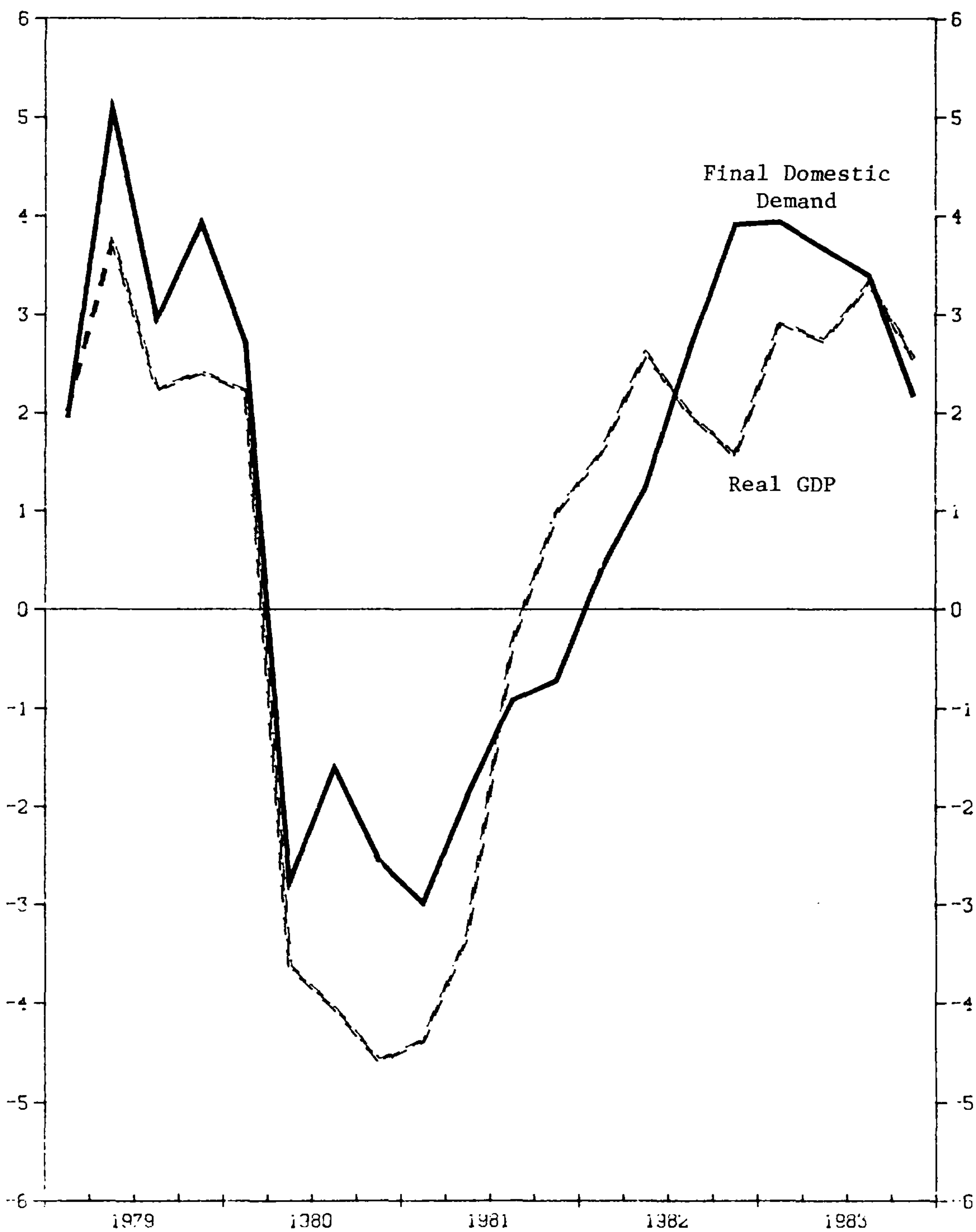
2/ In percent of labor force.

CHART 3

UNITED KINGDOM

OUTPUT AND DEMAND

(Annual Percentage Change at Constant Prices)

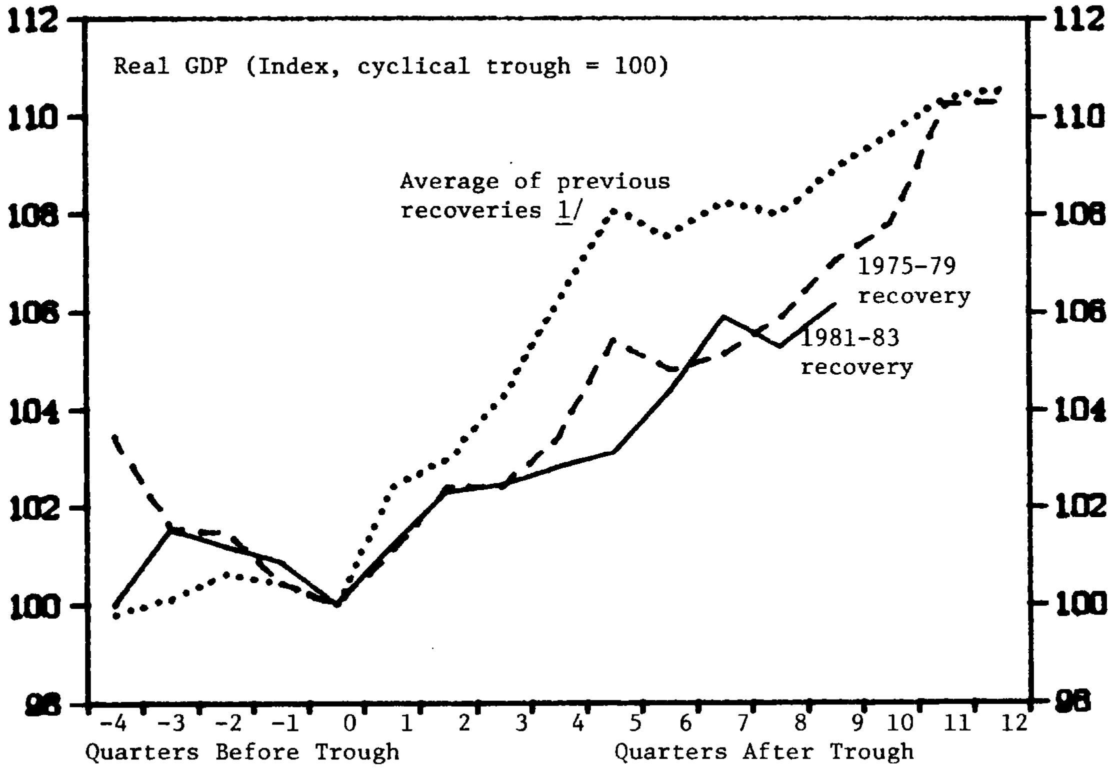


Sources: Data provided by the U.K. authorities; and staff estimates.

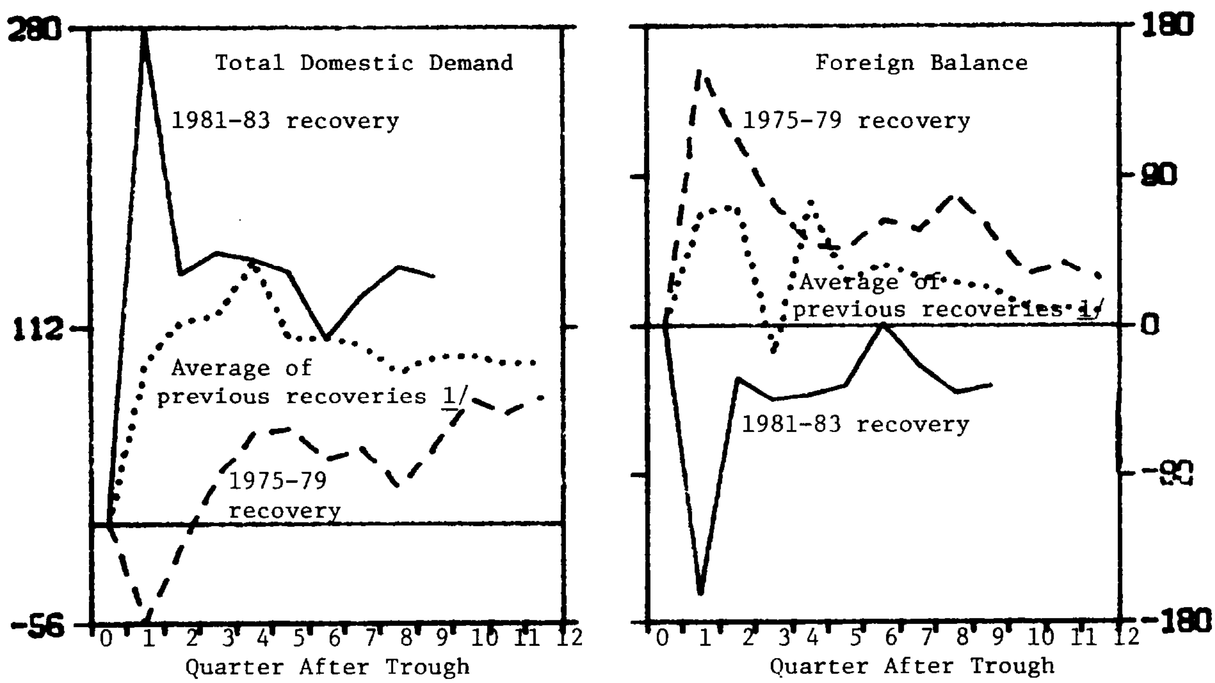
CHART 4

UNITED KINGDOM

CYCLICAL COMPARISONS OF OUTPUT AND DEMAND



CONTRIBUTIONS TO GROWTH IN REAL GDP; PERCENTAGES



Source: CSO, Economic Trends.
1/ Average of the 1963-64, 1966-69, 1972-73, and 1975-79 recoveries.

Table 2. United Kingdom: Domestic Developments and Forecasts

(Percentage change from a year earlier)

	1980	1981	1982	1983 1/	1984 1/
Demand and output (at 1980 prices)					
Private consumption	-0.5	0.2	1.4	3.7	2.6
Government consumption	1.7	-0.2	1.3	2.7	1.0
Investment	-5.2	-9.4	5.8	2.6	4.1
Public	-7.6	-15.6	-1.9	2.9	--
Private residential	-10.3	-17.5	6.8	...	...
Other private	-3.0	-4.8	9.3	...	...
Stockbuilding 2/3/	-2.5	-0.2	0.4	0.7	0.6
Total domestic demand	-3.5	-1.8	2.5	4.0	3.1
Foreign balance 2/	0.9	0.1	-0.4	-1.1	-0.3
GDP at market prices	-2.5	-1.7	2.1	2.9	2.8
Industrial production	-6.6	-3.9	2.0	1.9 4/	...
Manufacturing production	-8.6	-6.7	0.4	1.3	2.8
Prices, incomes, and employment					
Deflator for GDP at market prices	19.8	11.6	7.2	5.4	5.0
Retail prices	17.9	11.9	8.6	4.6	5.0
Average earnings 5/	20.7	12.9	9.4	7.7 6/	...
Unit labor costs in manufacturing	21.4	9.5	4.7	...	...
Unemployment rate (excluding school-leavers)	6.4	10.0	11.7	12.5 7/	...

Sources: CSO, Economic Trends; and information provided by the U.K. authorities.

1/ Official forecasts.
2/ Contribution to GDP growth.
3/ Including the compromise adjustment to GDP.
4/ First three quarters of 1983 over 1982 average.
5/ The 1980 figure represents 1976-based data and is not entirely comparable to figures for subsequent years which are January 1980 based.
6/ First ten months of 1983 over 1982 average.
7/ Based on data through November 1983.

however, consumer spending was not associated with a rise in real disposable income but with a sharp drop in the savings ratio which the U.K. representatives related to the decline in inflation and to the strong growth of consumer borrowing following the removal of restrictions on installment credit in July 1982. Fixed investment rose in 1982 and 1983, with nonresidential construction the most buoyant component. Manufacturing investment, which fell by over a third from its 1979 peak during the recession, has of late been showing signs of picking up.

The strong recovery in domestic demand since 1981 has not been fully translated into higher output. Although the volume of oil exports has continued to rise, the trade balance has deteriorated markedly (Tables 3 and 4 and Chart 5), and trade in manufactured goods moved into deficit for the first time in the country's history. The ratio of non-oil exports to imports (in 1980 prices) fell from 100 percent in 1980 to 86 percent in the first half of 1983; the corresponding ratios for manufactured goods show an even greater deterioration. The worsening in the trade balance reflects the earlier recovery of demand in the United Kingdom than in most trading partners and probably supply limitations in the United Kingdom linked to lagged effects of the sharp loss in competitiveness experienced in 1978-81. The current account of the balance of payments moved from a surplus of £6.5 billion in 1981 (2.6 percent of GDP) to a small surplus estimated at about £1 1/2 billion in 1983.

Table 3. United Kingdom: Trade and Current Account

(In billions of pounds)

	1980	1981	1982 1/		1983 1/	
			1st half	2nd half	1st half	2nd half 2/
Oil trade balance	0.3	3.1	3.1	6.1	6.5	6.5
Non-oil trade balance	0.9	-0.1	-2.4	-2.5	-8.2	-9.2
Current account	3.2	6.5	3.6	7.2	1.2	1.5

Sources: Data provided by the authorities; and staff estimates.

1/ Annual rates, seasonally adjusted.
2/ Estimate.

Table 4. United Kingdom: External Developments

	1979	1980	1981	1982	1983 Est. 1/	1984 Proj. 1/
			(In billions of pounds)			
Exports, f.o.b.	40.7	47.4	51.0	55.5	60.1	65.1
Imports, f.o.b.	44.1	46.2	48.0	53.4	62.2	68.9
Trade balance	-3.4	1.2	3.0	2.1	-2.2	-3.9
Services, IPD, and private transfers	4.9	3.8	5.2	5.2	5.5	5.9
Official transfers	-2.1	-1.8	-1.7	-1.8	-2.0	-2.1
Current account balance	-0.7	3.2	6.5	5.4	1.3	--
In percent of GDP	(-0.4)	(1.4)	(2.6)	(2.0)	(0.5)	(--)
Investment and other capital 2/	2.6	-1.9	-7.2	-6.7	...	...
Balance for official financing	1.9	1.4	-0.7	-1.3	...	...
Gross reserves, end-period (in billions of U.S. dollars)	22.5	27.5	23.3	17.0	...	...
			(Percentage change)			
Merchandise export volume	4.8	0.9	-0.8	2.6	0.6	...
Merchandise import volume	10.7	-5.4	-2.7	3.8	7.3	...
Terms of trade	1.6	4.5	1.7	-1.2	-1.0	...
Nominal effective exchange rate	7.1	10.1	-1.2	-4.7	-7.2	...

Sources: H.M.S.O., United Kingdom Balance of Payments; and staff estimates and projections.

1/ Staff estimates and projections.
2/ Including balancing item.

Although employment continued to fall through the first half of 1983 and the rate of unemployment reached 12.3 percent (seasonally adjusted) at the end of November 1983 compared with an average of 5 percent in 1979, various indicators pointed to an improvement in the labor market. Unfilled vacancies and hours worked have risen sharply during the past year and unemployment seems to be leveling off.

b. The role of policies

The staff team discussed with the U.K. representatives whether the recovery could be attributed to a change of course in financial policies. In FY 1981/82, the year when the recovery started, the impact of fiscal policy was severely restrictive, partly by design and partly because spending turned out to be lower than projected. In 1982/83, the under-spending turned out to be lower than expected at budget time and the actual PSBR exceeded the end-year estimate by £1.7 billion, though remaining within the budget targets. The higher-than-expected level of expenditure has persisted in the current fiscal year, prompting the authorities to announce in July 1983 measures to rein back spending. 1/ Nevertheless, the U.K. representatives expected the PSBR to be some £2 billion higher than foreseen at budget time. They viewed the slippage in public sector finances as temporary and expected that by FY 1984/85 developments would be back in line with the MTFS projections. The contrast remains, however, between the period from 1979 to 1982 when the general government financial deficit came down sharply in the face of adverse cyclical developments and the most recent period when the deficit has been stable or increasing slightly during an upswing in economic activity (Table 5).

Table 5. United Kingdom: Fiscal Policy Indicators

	1979/80	1980/81	1981/82	1982/83	1983/84	1984/85
			(In percent of GDP)			
General Government financial deficit	2.9	3.9	1.8	2.6	...	...
Public sector financial deficit	3.9	5.0	2.4	3.2	3.1	2.7
PSBR	4.9	5.7	3.5	3.3	3.3	2.4
PSBR adjusted for asset sales 1/	5.4	5.9	3.4	3.5	3.7	3.0
			(Percentage change)			
Public expenditure (volume)	0.2	1.5	2.8	1.6	0.6	0.4

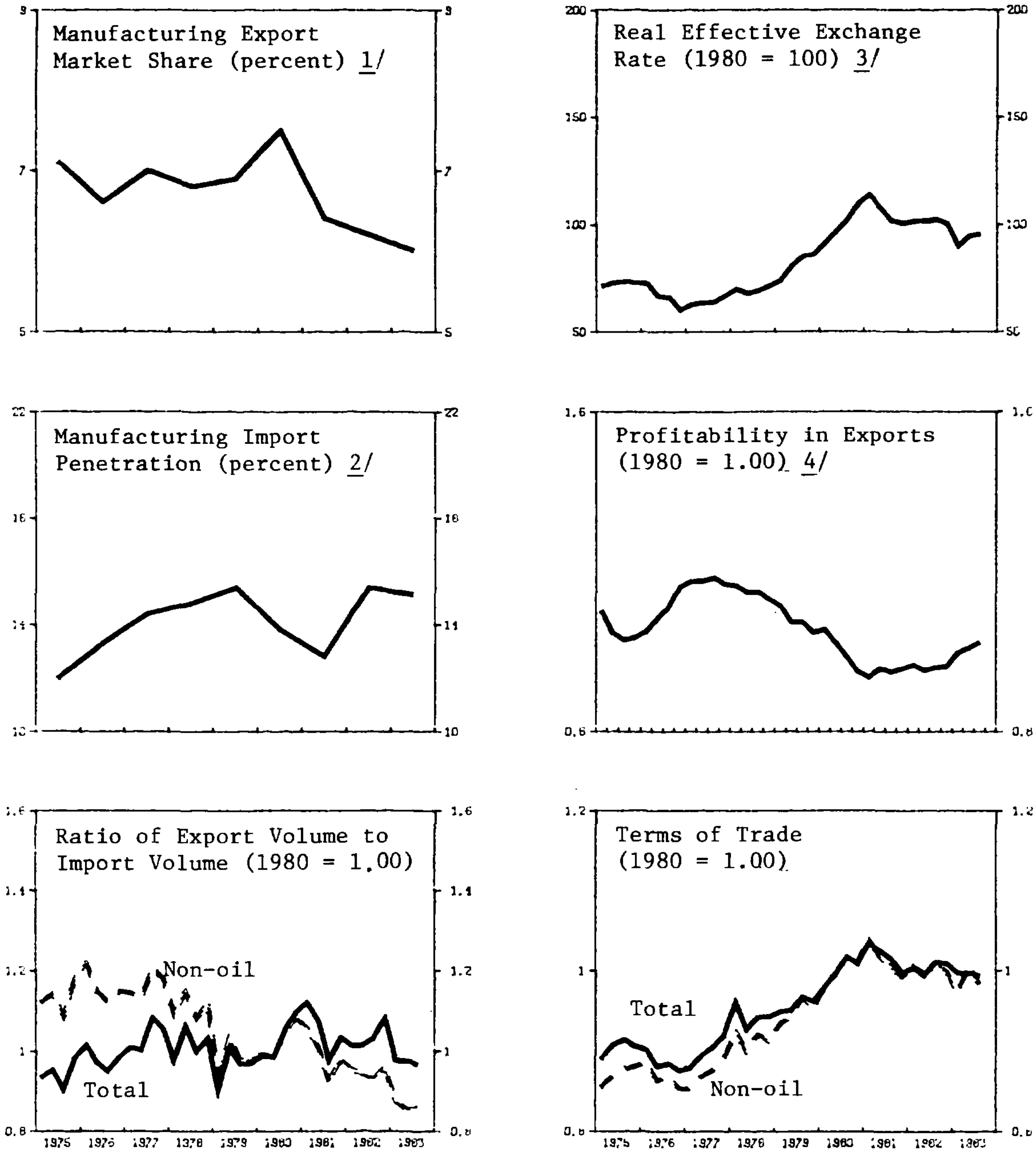
Sources: 1983 Autumn Statement; and data supplied by the authorities.
1/ Receipts from sales of assets, excluding council houses, are treated as a financing item rather than negative spending.

1/ The measures included a £0.5 billion reduction in expenditure subject to cash limits and £0.5 billion in additional asset sales.

CHART 5

UNITED KINGDOM

INDICATORS OF FOREIGN TRADE AND RELATED VARIABLES, 1975-83



Sources: CSO, Annual Abstract of Statistics; GATT, International Trade; IMF Data Fund; U.K. authorities; and staff estimates.

1/ U.K. share of manufacturing exports in world manufacturing trade at current prices: 1983 = estimate.

2/ Share of manufacturing imports in GDP at current market prices; 1983 = estimate.

3/ Relative normalized unit labor cost, adjusted for exchange rates.

4/ Ratio of unit value of exports to unit labor cost of manufacturing.

The growth of monetary aggregates decelerated between the second half of 1980 and the second half of 1982, but in the early months of 1983 it rose, largely in response to the increase in the PSBR, well in excess of the 7-11 percent target range for FY 1983/84 (down from 8-12 percent in 1982/83). The measures taken since July to reduce the PSBR and increased sales of government securities to the nonbank public contributed to a slowdown in monetary growth. However, in the last three months of 1983, the growth of the aggregates seems to have picked up again, with only £M3 within the target range, and only barely at that. In large measure, this has reflected the buoyancy of bank lending to finance the continuing surge of consumer spending.

The rapid decline in inflation has meant that the recorded rates of monetary growth in 1982 and 1983 have allowed ample room for a recovery of output and that the real money supply has expanded strongly, though at a slower pace in the past six months (Chart 6). After a temporary run-up around the end of 1982, interest rates have resumed their downtrend and are now below corresponding U.S. rates (Chart 7). Real long-term interest rates, based on the retail price index, have risen since mid-1980. Estimates based on other measures of price expectations show, however, a declining trend of real interest rates since 1981. Whatever the measure, the differential in favor of the United States has widened markedly since the end of 1982.

As in other countries, changes in saving behavior, financial innovation and the effects of sharp fluctuations in rates of interest or inflation have made the interpretation of monetary statistics difficult. As a consequence, the authorities have made use of supplementary indicators such as interest and exchange rates and asset prices in assessing the stance of monetary policy. The U.K. representatives agreed with the staff team that those indicators can be ambiguous. Interest and exchange rates, in particular, can be affected by developments abroad and by the fiscal-monetary policy mix. The U.K. representatives did not think that nominal income objectives could be used to guide monetary policy in the short run, although the target range for monetary aggregates embodied an implicit projection for nominal income. The progressive deceleration of nominal GDP in recent years (Chart 8) with an increasingly favorable split between increases in output and increases in prices could, however, be viewed as evidence of the success to date of monetary policy.

In conclusion, there was broad agreement between the U.K. representatives and the staff team that the recovery, which began with a turnaround in the stock cycle, had been nurtured by the progressive easing of financial conditions, which itself reflected the authorities' success at reducing inflation and the budget deficit. The recovery was strengthened in late 1982 and the first half of 1983 by a relaxation of the policy stance, which the authorities viewed as temporary.

c. The improvement in business conditions

Company profitability, which had been on a downtrend since the early 1960s, reached a record low (excluding North Sea oil operations) in 1981 and has risen noticeably since. Trading profits by 1983/3 were 30 percent higher than a year earlier, but still remain depressed by historical standards. Profits have benefited from the upswing in business activity and a better competitive position, as well as from a sharp deceleration in labor, fuel, and materials costs.

Wage increases have been progressively lower since 1979-80 but have remained positive in real terms in spite of the rapid increase in unemployment. The U.K. representatives noted that in the past two years pay settlements implied a decline in real wages on the basis of the then current rates of price increase, but because of the faster-than-expected decline in the rate of inflation they had resulted ex post in gains in real earnings. Reductions in employers' national insurance contributions have also helped reduce labor costs, but the main influence has been the large gains in productivity achieved since 1979 (Table 6).

Table 6. United Kingdom: Average Annual Productivity Growth

(In percent)

	Whole Economy	Manufacturing
1963-73	3	4
1973-79	1	1
1980/1-1983/1	2.7	4.1

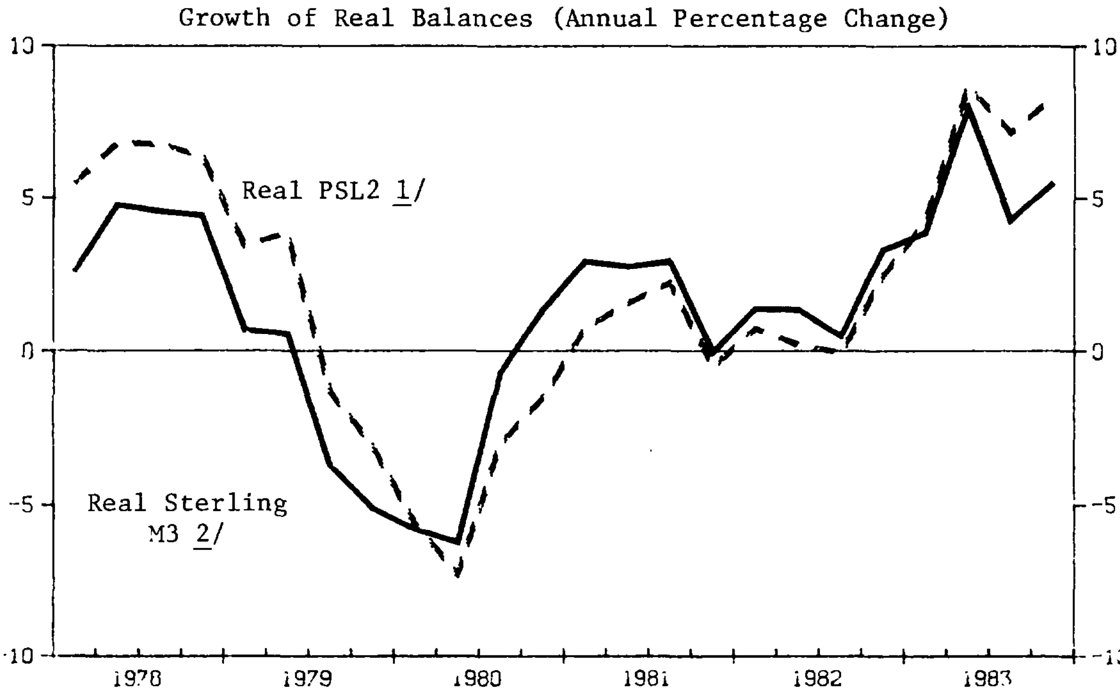
Source: Data provided by the U.K. authorities.

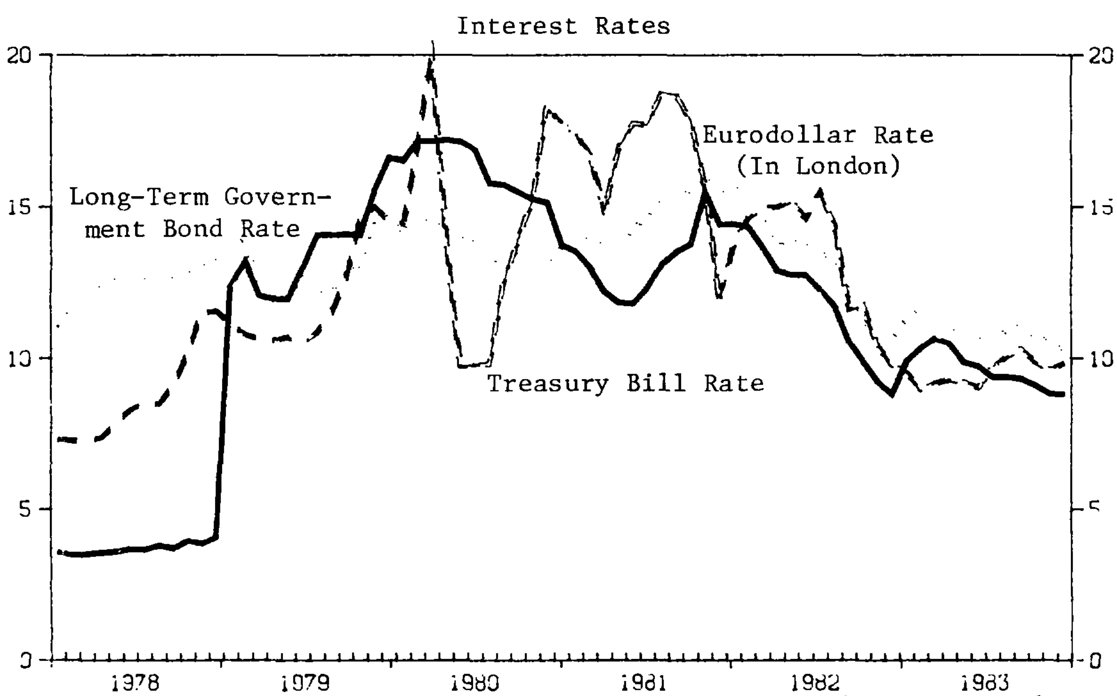
Contrary to past experience, productivity rose during the 1979-81 recession and during the subsequent upswing it continued to rise at a faster pace than would have been expected on the basis of past relationships. The U.K. representatives thought that the evidence suggested that there had been in the manufacturing sector not only a permanent upward shift in the level of productivity but probably also an increase in the underlying trend rate of productivity growth since 1979. Reduced labor resistance to improvement of working practices, as well as financial pressure, had strengthened the efforts to reduce overmanning. There was no conclusive evidence that productivity gains had resulted from a reduction in the share of low productivity firms within manufacturing. The staff team noted, however, that the rise in productivity had been accompanied by rising unemployment and a shrinking in the size of the manufacturing sector and that this could make it difficult for U.K. producers to translate productivity gains into a rising share of domestic and foreign markets.

CHART 6

UNITED KINGDOM

REAL MONEY GROWTH AND INTEREST RATES





Sources: IMF Datafund; data provided by the U.K. authorities; and staff estimates.

1/ PSL2 deflated by the CPI.

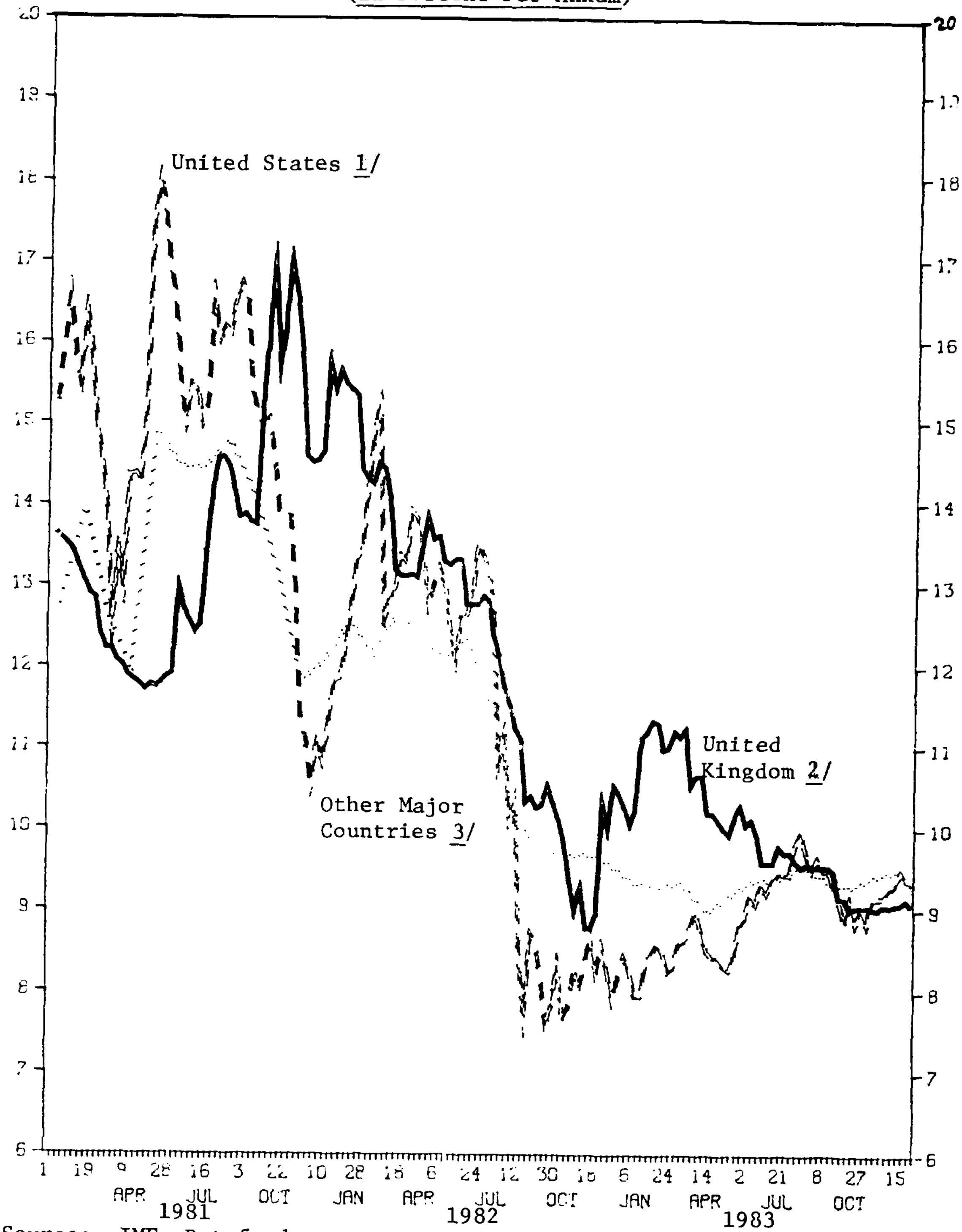
2/ £M3 deflated by the CPI.

CHART 7

UNITED KINGDOM

SHORT-TERM INTEREST RATES

(In Percent Per Annum)



Source: IMF, Datafund.

1/ Three-month Treasury Bill rate.

2/ Three-month Treasury Bill rate.

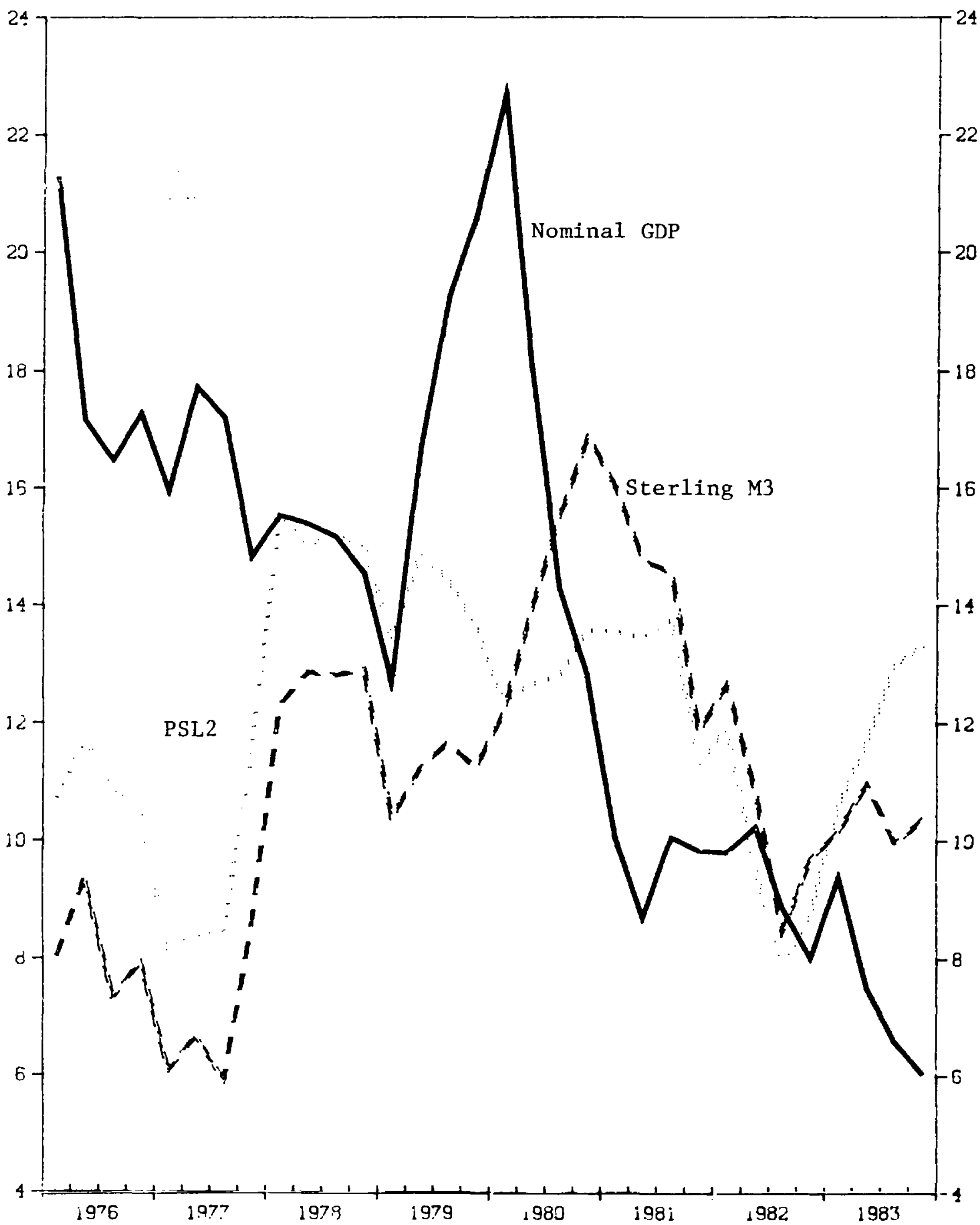
3/ Weighted average (MERM weights) of short rates for six major countries (including United States, excluding United Kingdom).

CHART 8

UNITED KINGDOM

MONEY AND GDP

(Annual Percentage Change)



Sources: Data provided by the U.K. authorities; and staff estimates.

The effective depreciation of sterling since the beginning of 1981 has also contributed to the improvement in competitiveness and profitability. Between 1981/1 and 1983/4, the effective exchange rate depreciated by about 18 percent. During the same period, normalized unit labor costs in the United Kingdom increased at broadly the same rate as the average for other industrial countries. As a result, the real effective exchange rate is estimated to have also depreciated by about 18 percent (Chart 9). It was, however, still some 34 percent above its 1978/1 level.

3. Short-term prospects

a. The domestic economy

The official forecast presented in the Autumn Statement of November 17, 1983 features a 3 percent increase in domestic demand and GDP in 1984, and a 4 1/2 percent rate of inflation (retail prices, fourth quarter). The main assumptions behind the forecast are a strengthening of the recovery in world trade, and financial policies in line with MTFS projections. Specifically, the latter means that the growth range for monetary aggregates would be 6-10 percent in FY 1984/85 (7-11 percent in 1983/84) and that the PSBR would be reduced to the equivalent of 2 1/2 percent of GDP, down from an estimated 3 1/4 percent of GDP in FY 1983/84. The composition of expenditure is expected to change in 1984 with exports and investment taking over from private and government consumption as the main demand stimuli.

Projections by private forecasters and international institutions are generally less optimistic as regards the prospects for growth and inflation in 1984. They foresee a sharper deceleration of consumer spending than the official forecast which assumes a further decline in the savings rate. The U.K. representatives thought that the scope for increases in household indebtedness, following the removal of restrictions on consumer loans by financial institutions, had not been exhausted, although they recognized that there remained considerable uncertainty as to the behavior of personal savings in 1984. Real disposable income might also turn out to be stronger than presently foreseen. The forecast of a 4 percent increase in real fixed investment was consistent with the results of business surveys. The U.K. representatives said that the improvement in the financial position of enterprises was such that investment expenditure might well be stronger than presently envisaged. They also took exception with the tendency to associate the continuation of the current recovery with a reacceleration of inflation. This was not inevitable and there was no indication that inflation was picking up. After a temporary rise in the first half of 1984 to about 5 1/2 percent, the rate of increase in consumer prices was expected to recede to about 4 1/2 percent by the end of the year. The U.K. representatives foresaw little change in the rate of rise in earnings as the effects of the high level of unemployment, the still unsatisfactory profit position of enterprises, and competitive pressures would broadly offset the effects of the recent improvement in profitability and in the employment situation. On the basis of the forecast for output and continued gains in productivity, though at a lower rate than in 1983, employment would expand in 1984 and might allow a small reduction in the rate of unemployment.

The U.K. authorities do not intend to make policy adjustments should actual economic developments turn out differently than forecast. This is consistent with the medium-term orientation of their financial policies and their rejection of "fine-tuning"; should inflation turn out to be higher than foreseen, for example, the present stance of monetary policy would result in tighter monetary conditions which might affect output growth adversely. Policy adjustments would be made, however, if as in the first half of 1983, fiscal and monetary aggregates deviated from their medium-term target path.

b. <u>The balance of payments and the exchange rate</u>

According to the official forecast, a further decline in the current account surplus to near balance is projected for 1984. Despite an acceleration of non-oil exports reflecting a strengthening of foreign demand, the trade balance would deteriorate further as the growth of imports continues to outstrip that of exports. Part of that deterioration would be offset by a larger surplus on invisibles, particularly from interest and dividends on the growing stock of foreign assets accumulated in recent years.

Besides the usual uncertainties with regard to the volume of world trade and the price of oil and raw materials, the foreign trade forecasts are sensitive to the view one takes of the competitive position of U.K. industry. The U.K. representatives thought that the loss in competitiveness experienced between 1978 and 1981, which was linked in part to the development of North Sea oil and the emergence of a sizable surplus on oil trade, had already had its full effect on trade flows and that the U.K. share of export markets should stabilize. They noted that the improvement in the competitive position since 1981 had been reflected in small market share gains (in volume terms) in 1982 and 1983. For 1984, they projected a further deterioration in the balance of trade in manufactures, based in part on the strong upward trend of import penetration, but the emerging deficit on trade in manufactured goods would be offset by a better performance of invisibles.

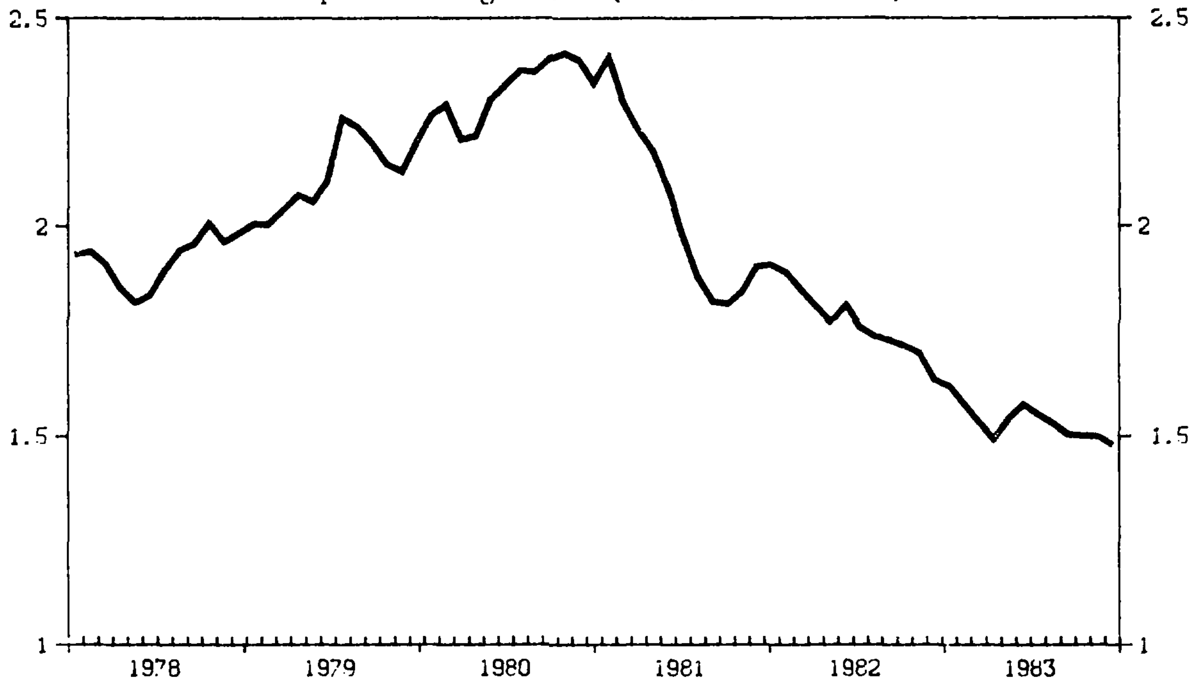
The staff team questioned whether the adjustment to the real appreciation experienced since 1978 had been completed and in particular whether the U.K. share of world trade in manufactures had stabilized. As already noted, the recent gains in competitiveness had been obtained at the cost of a further shrinking of the manufacturing sector and it was unclear whether the remaining enterprises could meet the demand from both domestic and foreign markets. The U.K. representatives acknowledged that the models used for projecting imports and exports did not take adequate account of supply factors, but they believed that some of the factors responsible for the long-standing weaknesses in British manufacturing and its declining share of world markets were losing significance.

CHART 9

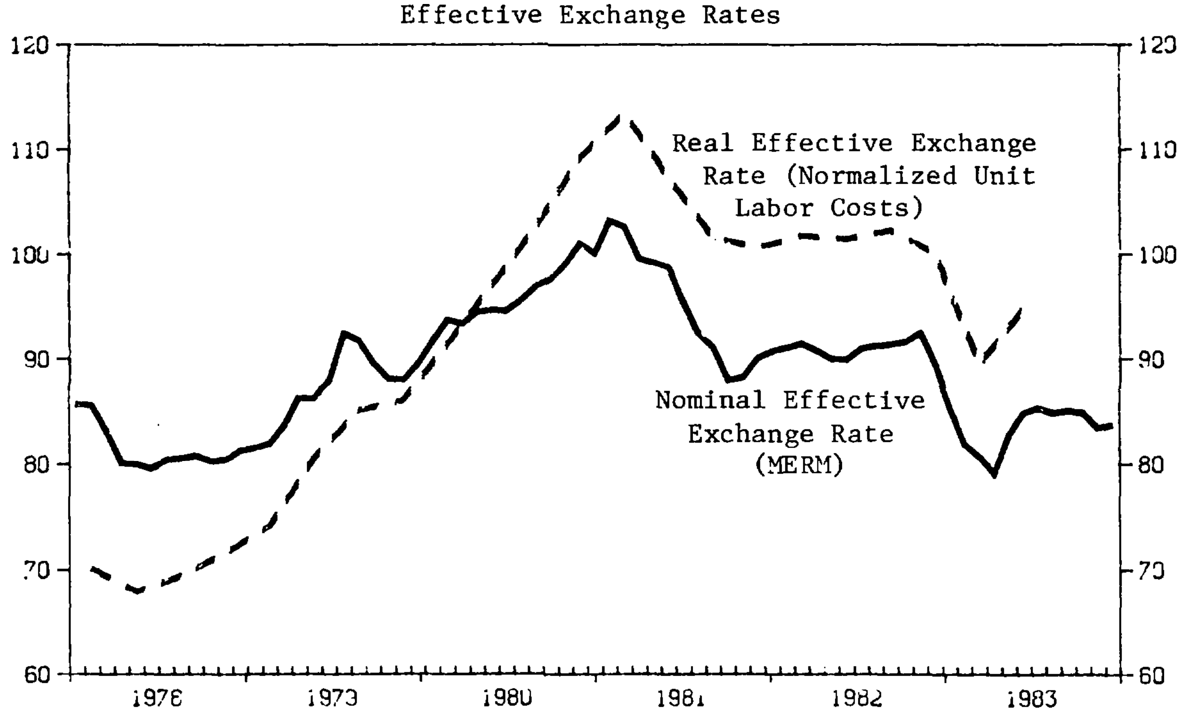
UNITED KINGDOM

EXCHANGE RATES

Spot Exchange Rate (Dollars Per Pound)



Effective Exchange Rates



Sources: IMF, Datafund; and staff calculations and estimates.

The expected weakening of the current account in 1984 would have its counterpart in a smaller capital outflow, probably on items other than portfolio investment as the adjustment to a higher share of foreign assets in U.K. portfolios after the abolition of exchange controls in 1979 was still continuing. Continued high interest rates in the United States would also stimulate some capital flows to that country on an uncovered basis. On the other hand, portfolio diversification was also proceeding apace in other major industrial countries and this would raise demand for U.K. securities.

There has been no change in the Government's exchange rate policy nor is any being considered. There continues to be no target--either implicit or explicit--for the exchange rate which remains determined by market forces. Intervention is limited to maintaining orderly markets and smoothing excessive fluctuations. (Official reserves increased by the equivalent of SDR 500 million in 1983.) The authorities would not attempt to prevent a weakening of the exchange rate by tightening monetary policy, unless the weakening was corroborated by other evidence that monetary policy had unintentionally become too loose. The U.K. representatives noted, however, that on the assumption that monetary policy remained on its medium-term course and refused to accommodate increased price pressures, a depreciation of the exchange rate might result in tighter monetary conditions. This could take place rather quickly if interest rates rose in response to the expectation of a rise in prices, or more slowly, through the effects on the rate of inflation unless the higher import prices were offset by lower domestic costs and prices. To the extent that the present real effective exchange rate was not consistent with a sustainable external position and a rate of growth that would allow some reabsorption of unutilized factors of production--a point on which the U.K. representatives did not express any view--the authorities would generally prefer to improve competitiveness by achieving a lower rate of increase in domestic costs than other countries, although they would not resist a depreciation of the nominal exchange rate.

4. Medium-term issues and policies

a. Financial policies

The U.K. authorities have reaffirmed their commitment to a medium-term framework for financial policies. The aims of the MTFS, when it was introduced in 1980, remain valid, viz., to lengthen the time horizon for policymaking; to direct policy toward nominal rather than real magnitudes; and to keep monetary and fiscal policies in proper balance. Notwithstanding difficulties of implementation in its early stages, the U.K. representatives thought that the MTFS had proved a valuable presentational framework and had had a favorable impact on expectations.

The principal objective of the MTFS continues to be the reduction of inflation. Although no timetable has been decided, price stability is the ultimate goal, and it is to be achieved mainly through a reduction in the rate of monetary growth. There is a presumption that in the next budget and thereafter the target range for M1 and the two broad monetary aggregates will be lowered. The authorities have announced that, in addition to the three aggregates, they may also target base money (Mo) which, in the United Kingdom, consists largely of currency and fills the need for an aggregate closely related to transactions. Mo may be substituted for M1 which, because of its growing interest-bearing component, is coming to resemble a broad aggregate.

The U.K. representatives agreed that monitoring several aggregates supplemented by various indicators implied that the conduct of monetary policy relied heavily on judgment but they saw this as reducing the risk of serious errors which rigid targeting of a single monetary measure would entail.

Within the MTFS, fiscal policy is directed at achieving a progressive reduction in public sector borrowing in order to sustain progress in reducing interest rates. The Chancellor of the Exchequer has warned that he would propose tax increases in his next budget (for FY 1984/85) if the planned reduction in the PSBR (to 2 1/2 percent of GDP) could not be achieved otherwise. Recent figures, showing that the PSBR (seasonally adjusted) has already in nine months exceeded its (revised) target for the whole of 1983/84, suggest that this may perhaps prove necessary. A further reduction to the equivalent of 2 percent of GDP in 1985/86 had been planned in the 1983 budget (Table 7). The recovery in economic activity should make it easier to achieve the projected reduction in the PSBR, as would the planned increase in asset sales. The staff team noted, however, that to the extent that the reduction in the PSBR came entirely from cyclical influences and asset sales, it was unlikely to result in any downward pressure on interest rates.

Table 7. United Kingdom: Medium-Term Financial Strategy

	1983/84	1984/85	1985/86
General government expenditure (in percent of GDP)	45.6	44.5	...
PSBR (in percent of GDP)	2 3/4	2 1/2	2.0
Money GDP (in percent, annual increase)	8.2	7.9	7.5
Money growth (in percent)	7-11	6-10	5-9

Sources: 1983 budget; and Autumn Statement.

The authorities continue to aim at a reduction in the growth of public spending which would allow them not only to meet their PSBR targets but also to reduce taxes. This is seen as particularly desirable in order to improve the incentive to work, especially for the lowest-paid workers whose earnings are close to what they would receive if they were unemployed, and to lower employment costs for enterprises. They have accordingly decided to freeze public spending in real terms for the next three years. This would, if achieved, reduce the share of public expenditure in GDP at the end of the period to about the level of 1978/79, or by about 4 percentage points below the 1981/82 peak. 1/ The U.K. representatives viewed the expenditure target as ambitious and implying further reductions in public employment (which fell by 5.5 percent from 1979 to 1982, the last year for which data are available) and severe cuts in those programs other than health, defense, and social transfers which the Government has promised to maintain. Efforts are already under way to constrain spending by local authorities. In order to prevent local authorities from raising taxes to finance increased spending, the Government has introduced legislation which would set limits to the rates of property taxes that individual authorities can levy starting in 1985/86.

The authorities have also given attention to the problems looming in the period beyond the three-year horizon of the MTFS. That period will be marked by a decline in oil production which is now expected to peak in 1984/85 and to fall off fairly sharply thereafter. For technical reasons, the impact on government revenue--receipts from North Sea oil account now for 7 percent of general government receipts--will be felt with a lag. At any rate, the U.K. representatives thought that as North Sea oil production tapered off, a real exchange rate adjustment would probably occur, although its timing and magnitude was uncertain.

A long-term issue which is viewed with concern is the trend of public spending. Because of demographic and other factors, a large part of public expenditure, such as health costs and pensions, would on present policies continue to grow faster than national income, so that the Government's objective of reducing the size of the public sector could only be achieved by compressing other types of expenditure, including public investment, to an extent which would be neither feasible nor desirable. Thus, while the Government is committed to preserving the basic principles of the welfare system,it nevertheless takes the view that some changes both in the type of services provided by the public sector and in the method of financing these services seem necessary. The possibility of relying on the private sector to provide supplementary benefits in areas such as medical care and pensions, and on direct charges rather than financing out of general revenue, is under discussion.

b. Policies for employment and industry

Properly speaking, the Government has neither an employment policy, nor an industrial policy. Although the Government has introduced a number of "Special Employment Measures," covering an estimated 600,000 persons, mostly young people, to deal with the situation resulting from rising

1/ Because asset sales are deducted from government expenditures, if they should increase in percentage of GDP, this would imply that expenditures proper could rise relative to GDP.

unemployment, and has provided training opportunities and taken steps to foster labor mobility, the authorities argue that they cannot determine when and where new jobs occur and that their ability to influence the level of employment is limited by the degree of flexibility of real wages. So far, that flexibility has remained insufficient as real wages have not declined to the extent necessary to maintain employment, given the evolution of productivity and energy prices (see the recent economic developments paper). The authorities have rejected the use of incomes policy to influence wage determination, but they recognize the importance of the limits set on the public sector pay bill in influencing settlements in the private sector. In 1983/84, the limit was 3.5 percent and a limit of 3 percent has been announced for 1984/85. The changes in labor legislation introduced in 1980-83 could also be expected to have a favorable impact on wage behavior, though the U.K. representatives thought this was difficult to assess. They regarded an acceleration of productivity gains as desirable, since the level of productivity in the United Kingdom remained well below that in the other main industrial countries. But if this was to be accomplished by substituting capital for labor, it might conflict with the objective of reducing unemployment.

The Government has introduced a wide array of financial incentives for enterprises, particularly for small businesses, which were viewed as successful, and some reform of regional incentives is under consideration. The U.K. representatives said that no major overhaul of company taxation was presently envisaged, though it was recognized that a system of fiscal incentives that would be both simpler and more neutral as regards the use of labor or capital in the production process would be advantageous.

The program of selling national enterprises to the private sector is to continue on a larger scale. The main aim of the privatization program is to improve efficiency and foster greater competition. The U.K. representatives said that reducing the PSBR was not a major aim of the program though the effect was welcome. Although most privatized companies had been in the private sector for a short time, initial results of the program were encouraging. Some large enterprises are to be privatized at a pace largely dictated by the absorptive capacity of the financial market. Some of these enterprises are monopolies and the authorities intend either to open up their activity to competitors or to provide for suitable regulatory arrangements. Targets for asset sales (excluding housing) in 1983/84 and 1984/85 are £1,250 million and £1,900 million, respectively, equivalent to 1 percent and 1.4 percent of general government receipts. However, the target for the latter year is based on a conservative estimate which could be exceeded by a sizable margin.

5. Trade and aid policies

For the first time, the consultation discussions included an extensive review of the United Kingdom's trade policies. Like most other industrial countries, the United Kingdom has not been able to resist all pressures for protection resulting from loss of competitiveness, the worldwide recession, and the actions taken by other countries. The recent rise in protectionism in the United Kingdom has taken the form of a significant increase in the incidence of nontariff barriers against imports of manufacturing products. Arrangements have also been made with supplier countries, particularly Japan, to implement voluntary export restraint measures (VERs) on automobiles and video and audio equipment. Most of these barriers were set up in accordance with EC directives, but some were erected on the basis of an informal agreement between industries at home and abroad. Furthermore, the number of temporary authorizations obtained from the EC Commission to limit free intracommunity circulation of goods under Article 115 of the Treaty of Rome has also increased significantly in recent years.

The U.K. representatives believed that the measures taken were in accordance with GATT rules, though they conceded that this had been questioned for some of them. They emphasized that the United Kingdom remained committed to an open international trading system. Protection was seen as a lesser evil than other means of coping with the excessive adjustment costs faced by certain manufacturing industries. Furthermore, it had not prevented adjustment completely; those sectors which were most heavily protected had also experienced the most severe reductions in employment and investment. The most protected sectors are agriculture, textiles and clothing, steel, and some manufactured products subject to strong competition from Japan.

The United Kingdom firmly supports the "roll-back" proposal made by the EC and other industrial countries, as well as the proposal for an acceleration, as the economic recovery proceeds, of the tariff reductions agreed by the Tokyo Round of Multilateral Trade Negotiations, and generally favors a dismantling of trade barriers based on reciprocity. The U.K. representatives also agreed on the need for greater transparency in foreign trade policy. They recognized that the Common Agricultural Policy (CAP) had resulted in relatively high prices and an oversupply for certain agricultural products at the expense of consumers and efficient third country suppliers. Given the budgetary and other implications of the CAP for the U.K. economy, the Government has supported proposals for reforming the CAP and reducing its costs.

In 1982, official development assistance (ODA) from the United Kingdom declined to the equivalent of 0.37 percent of GNP, from 0.43 percent in 1981. A major factor was the uneven pattern of disbursement of bilateral development assistance to India. The bulk of ODA is directed at the poorest developing countries. The aid program for FY 1983/84 is 8 percent higher than in the previous year and an increase of 5 1/2 percent is planned for FY 1984/85. Combined official and private flows to developing countries were equivalent to 1.3 percent of GNP in 1982.

III. Staff Appraisal

The United Kingdom's economy has been on an upswing since the first half of 1981 and the rate of inflation has declined to its lowest level in 16 years. The profitability and competitiveness of U.K. producers has been partly restored. The prospects for 1984 are for further growth--close to 3 percent for real GDP--with no reacceleration of inflation. The disappointing features of the current economic picture are the persistence of high unemployment, which seems to have stabilized around 3 million, with at best only a small decline foreseen for next year, and the continued weakening of the non-oil trade balance.

The recovery owes much to the success of the authorities' policies of reducing inflation and interest rates, though it no doubt drew some of its strength in 1983 from what the authorities view as temporary deviations of financial policies from their assigned paths. Monetary policy has achieved a progressive reduction in the growth of nominal GDP within which the lower rate of inflation has left greater room for an expansion of output. Fiscal policy has continued to aim at a reduction of budget deficits, though actual progress toward this goal has become slower since 1981/82. The mix of fiscal and monetary policies has generally been favorable. It has led to a reduction in real interest and exchange rates, and should allow investment and exports to take over from private consumption as the main sources of stimulus, thereby improving the prospects for the sustainability of the recovery.

The staff supports the medium-term orientation of financial policies and believes that deviations should only be allowed if the case in their favor is overwhelming. Steps were taken in mid-1983 to correct the budget deficit overruns and excessive monetary growth but there is as yet no clear evidence that financial policies are back on track. Monetary aggregates remain either at the top of their target range or above and their evolution will need to be watched closely. Persistence of monetary expansion at present or higher rates would endanger the authorities' anti-inflation strategy. Public sector borrowing continues to exceed the level of the previous year and the staff welcomes the Government's stated intention of returning in FY 1984/85 to the MTFS target for the PSBR and to hold public expenditure constant in real terms for the next three years. In implementing the latter objective, due allowance should be made for the growing importance of asset sales which should, in the view of the staff, be regarded as a financing item and not as an offset to expenditure. The current monetary targets leave room for continued real growth at present rates as long as inflation remains subdued, and the planned restraint on spending should allow both a reduction of the deficit and some tax cuts. Reductions in the tax burden, particularly for those workers whose earnings are close to the amount of unemployment compensation, and in employers' national insurance contributions would seem particularly desirable and helpful to the employment situation if they can be accommodated within the budgetary targets.

The staff sees no case for a more expansionary fiscal stance which would push up interest rates and the exchange rate for at best temporary gains in output and employment. Until incentives to hire new labor are restored through reductions in employment costs, the effects of demand expansion on the rate of unemployment are bound to be disappointing. As it is, with the exception of the next fiscal year when, in view of the budget overrun in 1983/84, the intended return to the MTFS objective for the PSBR would imply some withdrawal of fiscal stimulus, the targets for the PSBR would not be overly ambitious if economic recovery were to continue.

Exchange rate policy has remained flexible. The depreciation of the effective exchange rate since 1980 has contributed, together with a better relative cost performance, to an improvement in competitiveness. That improvement, however, has offset only part of the losses recorded since 1978, and some of the large productivity gains recorded in recent years has stemmed from the disappearance of a number of exporting firms, particularly in the manufacturing sector. Admittedly, the emergence of the United Kingdom as a major oil producer and exporter implies that a lower level of competitiveness might be acceptable. Nevertheless, the staff is not convinced that the present level of competitiveness is consistent with approximate current account equilibrium in the medium term and a rate of growth of output which would allow some reabsorption of unutilized factors of production. This would point to the desirability of further progress in reducing the rate of increase of domestic costs, as there are limits to the extent a deterioration in the external current balance can be averted by a depreciation of the nominal exchange rate, without resulting in unacceptable inflationary pressures. The experience of the past two years, when a decline in the nominal exchange rate took place without reversing the downward trend in the rate of inflation, suggests that these limits have not yet been reached. The staff also believes that a reduction in the structural public sector deficit over time could put downward pressure on interest rates and the exchange rate and contribute thereby to an improvement in competitiveness.

From a longer-term perspective, the staff believes that the expected decline in oil production and exports and the desirability of raising the level of productivity in the United Kingdom, which remains well below that of the other main industrial countries, call for shifting resources to exports and investment. This would be best accomplished by reducing public spending in terms of GDP. Lowering the PSBR by raising taxes is not an attractive option: it would reduce private saving and carry the risk of a tax-push to incomes and prices and of added disincentives to work or employment. The staff would hope, therefore, that early attention can be given to the main entitlement programs with a view to restraining their growth since it would be neither feasible nor desirable to direct all economizing efforts at the other categories of spending, including capital expenditures. Proposals for greater reliance on the private sector for the provision of certain supplementary health and pension benefits seem worthy of further consideration.

The staff agrees with the U.K. authorities that appropriate macro-economic policies are not sufficient to ensure a better performance of the economy. Structural actions that enhance the efficiency and flexibility of the economy are essential. Reductions in the size of the public sector, deregulation, and promotion of competition in labor, goods, and financial markets have an important role to play. Much has already been done: the extent of state control and intervention in the economy, as well as the ability of trade unions to resist changes in work practices and compensation that are more conducive to an expansion of employment and investment, have diminished. But, in the staff's view, much more remains to be done. Some of these "supply-side" measures take time to design and implement and their beneficial effects are felt after a lag. This would suggest that early action is desirable.

The staff would support, in particular, some changes in the area of investment allowances and financial incentives, which would lead to a system of corporate taxation that is simpler, reduces discrimination between sectors, and provides less encouragement for firms to substitute capital for labor. Another area is trade policy where, like many other countries, the United Kingdom has yielded to pressures for protection to certain sectors. The staff welcomes the U.K. authorities' support of limited trade liberalization and hopes that action will not be delayed until the recovery has made further headway. Reduced levels of protection, including protection to agriculture, would not just benefit foreign producers, but would also over time prove advantageous to the United Kingdom in terms of improved efficiency and lower costs and prices.

It is recommended that the next Article IV consultation with the United Kingdom take place on the standard 12-month cycle.

United Kingdom - Basic Data

Composition of GDP in 1982, at current prices	In billions of pounds	Distribution in per cent
Private consumption	167.1	60.9
Public consumption	60.1	21.9
Total investment (including stockbuilding)	41.0	15.0
Total domestic demand	268.2	97.8
Exports of goods and services	73.1	26.7
Imports of goods and services	-67.2	-24.5
GDP at market prices (expenditure estimate)	274.1	100.0

Selected economic data, average change in percent	1981	1982	1983 Estimate
Real GDP (at market prices, average estimate)	-1.7	2.1	2.9
Manufacturing production	-6.7	0.4	1.3
Average earnings	12.9	9.4	8.8
Retail price index	11.9	8.6	4.7
M1 1/	10.3	12.4	12.3
Sterling M3 1/	13.4	9.7	10.6
PSL2	11.5	8.8	13.6
Rate of unemployment (in percent)	10.0	11.7	12.6

Public sector accounts, in billions of pounds	1981/82 Outturn	1982/83 Outturn	1983/84 Estimate
General government receipts	111.9	121.7	128.0
General government expenditure	116.6	129.1	139.0
Financial balance	-4.7	-7.4	-11.0
Public corporations' financial balance	-1.3	-1.5	1.0
Public sector net lending	-2.7	-0.3	--
Public sector borrowing requirement	-8.7	-9.2	-10.0
(In percent of GDP)	3.5	3.3	3.3

Balance of payments, in billions of pounds	1981	1982	1983 Estimate
Exports	51.0	55.5	60.1
Imports	48.0	53.4	62.2
Trade balance	3.0	2.1	-2.2
Net invisibles	3.5	3.3	3.5
Current account balance	6.5	5.4	1.3
Investment and other long-term capital	-6.1	-3.5	-0.7 2/
External sterling liabilities	2.8	4.5	3.0 2/
Trade credits and other short-term capital 3/	-3.9	-7.7	-3.5 2/
Balance for official financing	-0.7	-1.3	0.5 2/
Gross reserves, official basis (millions of US$)	23.3	17.0	18.1 4/
Gross reserves, IFS basis (millions of SDRs)	13.8	11.9	11.8 5/
Average effective exchange rate index (1975 = 100)	94.9	90.5	83.2

1/ End-period.
2/ January to September.
3/ Including balancing item and allocation of SDRs.
4/ By end-November 1983, reserves revalued each end-March.
5/ By end-November 1983.

Fund Relations with the United Kingdom

(As of January 18, 1984)

Quota	SDR 6,194 million (increased from SDR 4,388 million under the Eighth General Review of Quotas).
Fund holdings of pounds sterling	SDR 4,183 million (67.54 percent of quota).
SDR position (January 23, 1984)	Holdings of SDR 523.5 million (27.4 percent of net cumulative allocations of SDR 1.9 billion).
Lending to the Fund under EAR	SDR 150 million.
Gold distribution (four distributions)	2,396,322.177 fine ounces.
Exchange system	The U.K. authorities do not maintain margins in respect of exchange transactions and exchange rates are determined largely on the basis of demand and supply conditions in the exchange markets. However, the authorities intervene when necessary in order to smooth out disruptive fluctuations in exchange rates. The exchange rate of sterling was £1 = US$1.4002 on January 25, 1984.
Last consultation	The staff report for the 1982 Article IV consultation (SM/83/18, January 24, 1983) was considered by the Executive Board on February 23, 1983.