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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 84/30

10:00 a.m., February 27, 1984

J. de Larosière, Chairman
W. B. Dale, Deputy Managing Director

Executive Directors	Alternate Executive Directors
	T. Ramtoolah, Temporary
J. de Groote	H. G. Schneider
B. de Maulde	X. Blandin
A. Donoso	
R. D. Erb	M. K. Bush
M. Finaish	
T. Hirao	T. Yamashita
J. E. Ismael	
R. K. Joyce	
	H. A. Arias, Temporary
G. Laske	G. Grosche
	I. Angeloni, Temporary
	A. S. Jayawardena
Y. A. Nimatallah	
J. J. Polak	T. de Vries
	K. G. Morrell
	H. Alaoui-Abdallaoui, Temporary
	E. I. M. Mtei
M. A. Senior	
J. Tvedt	A. Lindø
N. Wicks	T. A. Clark
Zhang Z.	

L. Van Houtven, Secretary
R. S. Laurent, Assistant

Also Present

Asian Department: R. J. Hides, S. Kashiwagi, I. Otani. European Department: P. de Fontenay, O. J. Evans, P. Gotur, M. T. Hadjimichael, S. Mitra, J. K. Salop, S. M. Thakur. Exchange and Trade Relations Department: C. D. Finch, Director; H. W. Gerhard, R. Pownall. Fiscal Affairs Department: M. Katz. Legal Department: S. A. Silard. Research Department: J. M. Boughton, M. D. Knight. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: C. J. Batliwalla, S. E. Conrado, J. Delgadillo, S. El-Khouri, K. A. Hansen, G. E. L. Nguyen, Y. Okubo, I. R. Panday, M. Z. M. Qureshi, D. C. Templeman. Assistants to Executive Directors: J. R. N. Almeida, M. Eran, G. Gomel, D. Hammann, N. U. Haque, M. J. Kooymans, J. A. K. Munthali, G. W. K. Pickering, M. Rasyid, J. Reddy, D. J. Robinson, Wang C. Y.

1. UNITED KINGDOM - 1983 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1983 Article IV consultation with the United Kingdom (SM/84/35, 1/31/84; and Sup. 1, 2/24/84). They also had before them a report on recent economic developments in the United Kingdom (SM/84/43, 2/13/84).

Mr. Wicks made the following statement:

On behalf of my authorities, I thank the staff for their interesting and comprehensive papers. My authorities generally endorse the staff's assessment of the U.K. economy. Two years ago, my predecessor said in his statement for the 1981 Article IV discussion: "The Government's economic strategy has two linked objectives: to bring down the rate of inflation in order to create conditions for sustainable growth in the medium term; to improve the supply side by restoring a more flexible and competitive market economy and providing better incentives for enterprises." These objectives have not changed, and neither has the broad approach to policy.

Macroeconomic policy continues to be set within the framework of the Medium-Term Financial Strategy (MTFS), which is designed to maintain fiscal and monetary discipline, to provide a stable environment for decisions in the economy generally and, as a particular aspect of this, to secure a sustained reduction in inflation. The general thrust of policy has been clearly maintained even though, as the staff paper points out, there have been modest deviations from the targets both for the fiscal deficit and for the growth of the monetary aggregates. Such consistency is of central importance so far as expectations and the credibility of policy are concerned.

Macroeconomic measures have been complemented by various supply-side policies. An important reason for the United Kingdom's disappointing economic performance in the past has been the extent of rigidities and distortions in many sectors but particularly, perhaps, in the labor market. These rigidities were not peculiar to the United Kingdom, but in some respects they had perhaps become more widespread and more deeply entrenched there than in many other industrial countries. It has been a principal aim of the Government to reduce or eliminate these rigidities, and to allow market mechanisms to function more effectively. With this in mind, my authorities have taken a large number of measures to increase incentives for enterprise and initiative, to eliminate restrictive labor practices, to foster competition and efficiency, and to remove unnecessary state controls and unwarranted state involvement in various parts of the economy. The benefits of such supply-side measures inevitably take some time to appear and can be difficult to distinguish, but they are now becoming increasingly apparent.

The recovery that began in 1982 continued through 1983. GDP last year was about 3 percent higher in real terms than the year before. At the same time, consumer price inflation averaged 4.6 percent, the lowest figure for 16 years. As usual at this stage of the cycle, the strongest components of demand have been consumption and stockbuilding. In contrast to previous experience, however, the buoyancy of consumption has mainly reflected a sharp drop in the savings ratio, as the rate of inflation has fallen, rather than budgetary or monetary stimulation. The elimination of hire-purchase controls has also made a contribution. These factors may exert a weaker influence in 1984, although the latest figures for retail sales, and survey results from the distribution sector, suggest that consumer demand may continue to be strong for some time. But my authorities expect, in line with many outside forecasters, including the OECD, that the recovery will now become more broadly based, with export and investment growth beginning to play a more important role. The latest industrial surveys tend to confirm this picture: for example, the official survey of investment intentions published in December pointed to a real increase of 9 percent in manufacturing and 6 percent in service sector investment this year, and the most recent inquiry by the employers' organization, the Confederation of British Industry, suggests a widening of the recovery from consumer to capital goods companies. Recent developments in exports have also been encouraging, with non-oil export volume rising by 8 percent in the last quarter of 1983.

As for fiscal and monetary trends, final figures for 1983/84 are not yet available, but the growth of all three monetary aggregates over the last six months has been at or below the midpoint of the target range. On the fiscal side, the public sector borrowing requirement remains in line with the forecast of 3.3 percent of GDP provided in the Chancellor of the Exchequer's Autumn Statement. On the exchange rate, my authorities continue to take the view that determination of the rate must rest principally with the market and that it would be inappropriate to adopt an exchange rate target. However, in assessing financial and monetary conditions, in judging the degree of financial pressure on the economy and in interpreting the monetary aggregates, movements in the exchange rate--and indeed other indicators--are taken into account.

On unemployment, my authorities believe that durable progress in reducing the rate will require improved competitiveness in industry. This, in turn, calls for more efficient working practices, the willingness of employees to accept new technology, and, most immediately, a realistic rate of pay increases. Progress has been made in all three areas. Productivity in manufacturing is 20 percent higher now than in 1980. And the indications are that wage settlements in the economy are generally lower than they were at a comparable stage in last year's pay round, although my authorities believe that they are still too high. There have recently been some encouraging signs of the beginning of a turn-around in the labor market. In the latest quarter for which information is available, the total number of people in employment rose, the first such rise in nearly four years. And short-time working is at its lowest level since 1980. The Government has helped by providing a sound and stable policy environment, but the main responsibility for further progress must rest with management and employees.

Looking beyond the present year, it is clear that the U.K. economy will continue to undergo structural evolution. The extent of past changes has been evidenced by shifts in the pattern of employment--where over time the proportion of the labor force working in the services sector has tended to rise and in the manufacturing sector to fall--but is also shown by the changing composition of the balance of trade. My authorities recognize that such changes reflect secular economic and social forces that are unavoidable.

These shifts have, understandably, brought pressure for government measures to lessen the impact on sectors subject to a secular contraction, especially pressures to impose trade restrictions. My authorities are, however, committed to the maintenance of an open trading system and firmly support the objectives of the present rollback exercise. In this regard, I would note that in many industries where trade restrictions are in force--for example, metal manufacturing and textiles--there have nevertheless been, as indicated in Table 60 of SM/84/43, substantial adjustments over the last five years, particularly substantial declines in employment. My authorities place great emphasis on encouraging structural flexibility so as to accelerate and ease the process of change. Equally, they are convinced that the exact manner and direction of change must ultimately be determined in the market place.

I have mentioned the importance that my authorities attach to continuity of policy. Macroeconomic policy will, therefore, continue to be framed in the context of the MTFS. My authorities very much agree with the staff judgment that a more expansionary fiscal stance than that envisaged in the MTFS would be inappropriate. The public expenditure plans recently published provide for a 5 percent increase in cash terms in the financial year beginning this April, with an increase of 4.5 percent in 1985/86 and 3.5 percent in 1986/87. With falling inflation, this is likely to imply that the level will stay broadly constant in real terms. Further efforts are being made to improve control of public expenditure and of the public sector borrowing requirement. From April 1, the role of the public expenditure contingency reserve will be extended to cover any overrun in demand-determined expenditure. Last July, the Chancellor announced that a degree of flexibility between financial years would be introduced in the limits for capital spending. My authorities have also recently introduced a bill to improve the control of local authority expenditure, by giving the Government the power to "cap" local tax increases where local councils have consistently overspent.

In the longer term, as in other industrial countries, public expenditure will be under upward pressure from demographic shifts and from the effects of technical change. For example, the proportion of the population aged over 75, who require a great deal more medical treatment than the average, continues to increase. On top of this, the costs of making available the latest medical techniques have escalated. Again in the long term, the maturing of the pension scheme related to state earnings, which began in 1978, will add substantially to the burden of pension expenditure. My authorities have recently announced a major review that will consider the future development, adequacy, and costs of state, occupational, and private provision for retirement. They believe that these wide-ranging issues deserve extensive public debate, and they propose to publish a discussion paper on longer-term public expenditure and taxation prospects. On the revenue side, they believe strongly that the level of taxation remains too high; within the constraints of the MTFS, priority will be given to bringing about some reduction.

In order to stimulate competition and efficiency, my authorities intend to continue with the program of transferring public sector corporations to the private sector. More generally, government action to enhance the supply capacity of the economy is in progress or planned. Efforts will continue to improve labor mobility and to reduce the rigidities in the labor market. For example, legislation is planned to help protect the pension rights of those who change jobs. Sales of publicly owned housing will continue, and those who at present rent such housing will be given the right to exchange their homes. In the financial markets, the abolition of stock exchange commissions and other reforms reducing the costs associated with transactions in securities should bring greater competition and efficiency.

A further important aspect of the medium-term outlook concerns the balance of payments. In this connection, one element is the likely path of oil production from the North Sea. On present estimates, production is expected to peak later in this decade, but even this is not certain and depends partly on the results of exploration now in progress and on the economic viability of enhanced techniques for recovering oil from existing fields. It is worth noting, however, that while the balance of payments benefit from North Sea oil may level off, the past effect on the current balance has contributed, over the last four years, to a substantial net accumulation of external assets. This, in turn, has tended to strengthen the net IPD (interest, profits, and dividends) component of the current account. In addition, there have been various longer-term changes, reflecting a redistribution of productive capacity from the traditional manufacturing sector to newer industries. Although, therefore, the balance of trade on manufactured goods has tended to worsen, this trend should not be viewed in isolation.

In summary, my authorities intend to continue their present broad approach to economic policy. In the more stable environment that these policies have brought about, they look for further strengthening in the supply capacity and competitiveness of the economy so as to support the resumption of sustained growth.

Mr. Erb commented that, under the approach taken by the present Government since 1979, the achievement of noninflationary monetary growth and a reduction in the public sector borrowing requirement were to be the key macroeconomic policy tools, to be complemented by a reduction in the Government's role in the economy and by other structural reforms. The authorities' innovative approach to economic policymaking represented a sharp shift from the previous orientation, when short-run demand management targets concerning growth, employment, and the external balance had driven monetary, fiscal, and structural policies. But, had the Government begun to lay the foundation for more stable economic growth over the longer term? Even though more than four years had passed, he found it difficult to judge.

On the monetary front, the authorities had made considerable progress in reducing inflation, Mr. Erb noted. In view of the priority being given to that objective, he was confident that still further reductions were going to be possible. The authorities had been less successful in bringing down the fiscal deficit, even though the U.K. economy had begun to recover. Again, while they had taken some steps to reduce the role of the Government by promoting deregulation and selling off some equity holdings in public corporations, only a modest reduction in the Government's importance in the economy--as measured by the ratio of fiscal receipts and expenditures to GDP--had occurred or appeared likely to occur. Arresting the growth of expenditure had proved difficult, although the ratio of expenditure to GDP had stabilized from 1981/82 through 1983/84 and was projected to fall by about 1 percentage point in 1984/85.

Some progress had also been made in reducing the public sector borrowing requirement of local governments and public corporations, Mr. Erb continued. Nevertheless, the Central Government had considerably expanded spending on defense and entitlements in the form of social security; increases in health care costs had proved particularly intractable, as in a number of other industrial countries. For instance, of the £26 billion increase in cash expenditures between 1980/81 and 1983/84, almost 43 percent was accounted for by social security, more than 18 percent by defense, and more than 15 percent by health and personal services. Almost three fifths of the 1983/84 budget was taken up by expenditures in the categories of defense, entitlements, and health, all of which the authorities had promised to maintain. It would be a notable achievement if they succeeded in freezing public spending in real terms over the next three years, as proposed. Whether they would manage to do so remained to be seen.

In restructuring the economy, the authorities had reduced rigidities in the labor, goods, and financial markets by removing controls over wages and prices, capital movements, investment location, bank operations, and the stock exchange, Mr. Erb said. The elimination of controls on international capital flows still seemed to be having an uncertain impact on the structure of the capital account, as portfolio adjustments continued and relative investment opportunities changed in the United Kingdom and abroad. Unfortunately, despite some progress in reducing rigidities in labor practices, the continued high rate of real wage increases raised doubts about future business profitability. It also raised doubts about the prospects for U.K. competitiveness and the Government's desire for a shift from consumption to exports and investment.

There had been some recovery in gross fixed investment, and the latest business survey was encouraging, Mr. Erb noted. Investment in plant and equipment had gone up faster than total investment, the manufacturing sector having performed worse than other sectors. The relative sluggishness of investment in manufacturing raised the broader questions whether, in general, the restoration of profitability had gone far enough and whether the loss of international competitiveness due to the prolonged real effective appreciation of sterling following the North Sea oil boom had been sufficiently offset by the subsequent depreciation. Clearly, the authorities' greatest success in achieving macroeconomic objectives had been the sharp decline in the rate of inflation.

He had been particularly struck by the steady decline in the rate of employment since 1980, a topic on which Appendix IV in SM/84/43--and the recent staff study in DM/84/6, which assessed the relationship between real wages and employment in the United Kingdom and Japan--offered interesting evidence, Mr. Erb remarked. He would follow with interest the effects on employment in the United Kingdom of the various new and expanded training schemes described in Appendix I of SM/84/43. However, greater competition within the labor market, reducing the rate of growth of real wage increases, seemed necessary for improving the rate of employment.

As to the external accounts, Mr. Erb continued, the staff had correctly highlighted the question of U.K. competitiveness, noting losses in market shares from 1979 through 1981, although market shares had apparently stabilized in 1982/83. In addition, exports had performed better than expected in the last quarter of 1983.

In sum, the U.K. authorities had embarked on an ambitious effort to restructure the economy by creating incentives for and removing impediments to private sector growth, Mr. Erb concluded. They had reduced the size of Government, eliminated many economic controls, and also laid the basis for price stability and a more consistent fiscal policy. Not all the reforms had yet been put in place, but the initial effects appeared favorable, especially the slowdown in inflation and the improved climate for private investment. By contrast, the unemployment picture appeared less favorable, and the balance of payments prospects remained uncertain. Several areas of particular concern should be monitored closely with a view toward possible policy actions: the rate of increase in real wages, the recent decline in the personal savings rate, the adequacy of the country's international competitive position, and the difficulty in limiting the growth of public spending, especially of entitlements.

Mr. Angeloni expressed sympathy for the authorities in pursuing their objectives of reducing inflation and stimulating the private productive sector in an environment of greater flexibility and competition. In moving to bring down inflation, the authorities had rightly identified a relatively tight fiscal policy as the necessary precondition for monetary restraint, and they had organized the Medium-Term Financial Strategy (MTFS) according to that principle. The interactions between fiscal and monetary policies, the role of budget constraint, and the implications of those elements for the stability of financial markets had recently been reviewed, with additional emphasis being placed on the role of expectations. Much of the current turmoil in the world's financial and exchange markets could be explained by the lack of policy coordination within individual countries as well as among different countries. Nevertheless, there remained considerable room for debate on how well the U.K. authorities had pursued their objectives and how closely the actual outcomes corresponded to the original goals. The staff papers were detailed, although less explicit in their judgments and evaluations than in the past.

From the peak rate of 1979, the U.K. authorities had brought about a dramatic fall in inflation, Mr. Angeloni noted, despite a remarkable downward rigidity in the rate of growth of real wages and one of the greatest shifts in productive structure recently experienced by an industrial country. The shift had reduced the relative size of the manufacturing and tradable goods sectors in favor of the services and nontradable sectors. Correspondingly, the structure of the balance of payments had changed: the non-oil trade balance had worsened, while the balance on petroleum and petroleum products had improved. The balance on services, traditionally in surplus, had remained fairly constant during the past four years.

The first question to be asked was to what extent the dramatic reduction in the size of the manufacturing sector had been warranted and whether it corresponded to the authorities' original idea of promoting productivity and competitiveness in industry, Mr. Angeloni remarked. Increases in productivity could hardly be interpreted as favorable developments when coupled with massive unemployment and reductions in actual and potential production by the tradable sector, for such increases would not necessarily translate into any gains in the country's trade performance. At the same time, the fall in manufactured output and in employment had probably affected not only unskilled workers but also relatively qualified ones, implying an overall deterioration in the United Kingdom's human capital. Those negative developments could be accepted as short-run, unavoidable steps toward building a more efficient economic structure only if there were reasonable prospects in the medium term for restoring high employment, with a greater share of output being generated by firms with high productivity. Such developments had so far failed to materialize.

Commenting on the medium-term outlook for the balance of payments, Mr. Angeloni observed that the shrinkage of the manufacturing sector had been accompanied by a sharp deterioration in the non-oil trade balance. Given the changes that had occurred in the U.K. supply structure, it was doubtful whether a sizable reversal of the trend could result from more favorable developments in the real exchange rate of sterling. At the same time, little improvement had taken place in invisibles, while the strong performance of the oil sector had partly compensated for unfavorable developments in non-oil trade. Nevertheless, the supply of petroleum could begin to diminish before the end of the 1980s, and it was unclear how the United Kingdom could compensate for the resulting export deficiency.

Although the authorities had the opportunity to create conditions for a stronger industrial recovery, particularly to restore the rate of capital formation in manufacturing, Mr. Angeloni went on, might not such efforts endanger the progress achieved in bringing down inflation? The evidence indicated a remarkable downward inflexibility of real wages, even at a time of substantial slack in the labor market, but it was still possible that wages might promptly move upward in response to a fall in the rate of unemployment. Given the circumstances, some sort of informal incomes policy might improve the conditions of the trade-off between inflation and unemployment and might allow the authorities to speed up the recovery without setting off sizable repercussions on the price front. Agreement on income dynamics might be more easily made acceptable to the social partners if the benefits in terms of stimulating recovery and employment could be demonstrated.

He welcomed the intention of the U.K. authorities to remain committed to an open trading system, Mr. Angeloni said. However, the recent trend toward wider trade restrictions, described in Appendix VIII of SM/84/43, should be regarded with concern, particularly to the extent that the restrictions were attributable to the difficulties being experienced by the industrial sector in connection with the authorities' policy stance. As one of their main policy goals was to revitalize domestic industry by fostering competition, it appeared contradictory and harmful to limit any chances for success by enlarging the sphere of protectionism.

In conclusion, he found himself in overall agreement with the objectives being pursued by the U.K. authorities, despite increasing difficulties, Mr. Angeloni remarked. He would however reiterate his concern about the consequences that continuing restrictive policies and overappreciation of the real exchange rate might have on the U.K. productive structure. There was a danger that the manufacturing sector might shrink beyond the point required to restore efficiency and establish a better balance among the components of production. Finally, the consequences of the authorities' policies should in no instance constitute an inducement for them to impose further protectionist measures.

Mr. Joyce observed that the U.K. authorities had been successful in dealing with a number of serious problems that had traditionally beset the economy. Indeed, since 1981, the United Kingdom had been leading the recovery in Europe. The most noteworthy recent development had been the dramatic reduction in price inflation and the somewhat slower deceleration in wage inflation. Together with some of the more basic structural changes carried out by the authorities, the inflation slowdown had helped to bring about a partial restoration of profitability and competitiveness in industry. Progress had clearly been buttressed by rapid increases in productivity brought about in large part by the closure or bankruptcy of less efficient enterprises and, more generally, by the shedding of excess labor. Yet he was concerned by the recent divergences of financial policies from planned trends, notably with respect to the targets for the public sector borrowing requirement (PSBR) and monetary aggregates. Looking ahead, he was also concerned about the continuing high rate of unemployment, the apparent diminution in the size of the manufacturing sector--which might well be only temporary--and the medium-term prospects for productivity growth.

The United Kingdom had made considerable progress, for which the authorities were to be congratulated, Mr. Joyce continued. The question was whether the recovery could be sustained through the medium term. Did the authorities have the willingness and determination to hold to the course that they had been following since 1979, despite the considerable costs involved? While the answer might be a qualified yes, even in the short run they would not have plain sailing. For example, GDP growth in 1984 might be less rapid than the estimates made by the Exchequer. Although household disposable income might rise, the high level of personal debt in relation to income could become a constraint on consumer spending, and the savings ratio might not decline as far or as fast as the authorities assumed. Even if business fixed investment turned out to increase as rapidly as they hoped, it could well lead to a greater deterioration in real foreign balances than was being projected. The real test would come in the medium term and would depend not only on developments outside the United Kingdom, but also on the ability of the U.K. authorities to stave off pressures to abandon fiscal and monetary restraint as well as on their willingness to continue dealing with structural rigidities.

The Medium-Term Financial Strategy was crucial and had to be pursued vigorously, Mr. Joyce remarked. As the staff noted, there had been a tendency to date to opt for fine-tuning, at least in the short run: pursuit of the MTFS had varied in intensity depending on external and internal circumstances. For instance, the financial deficit of the Government had narrowed sharply between 1979 and 1982, a time of adverse cyclical developments. On the other hand, the deficit had been stable or widening during the past year or so. Looking ahead, he welcomed the authorities' intention to offset the recent budget overruns. In the past, they had given a high priority to reducing the PSBR, but at the cost of substantially increasing the tax burden. In his view, they should emphasize spending less rather than taxing more. He was also concerned that they displayed no apparent interest in considering a reform of the tax system itself. As the staff pointed out, selective tax reductions, within the overall budgetary stance, could usefully help to reduce operating costs for firms and could increase incentives to expand employment. In planning for the longer term, the authorities should be aware that rising revenues from North Sea oil had contributed greatly to reducing the PSBR since 1980/81 but that such revenues would probably diminish after 1986/87. Finally, they should continue their efforts to trim public sector employment over the medium term.

On the monetary side, the authorities' strategy called for a close monitoring of the growth of monetary aggregates, currently expanding at a rate at or above the top of the target range, Mr. Joyce went on. Continued expansion at the current rate or an even higher one would present a threat to the Government's anti-inflation efforts. But the authorities had to move carefully in bringing the aggregates back within the target range. Recently, the acceleration in growth of the money supply had been linked to expanded lending to the private sector; tightening monetary policy at a time of a continued large PSBR could force up interest rates and abort recovery. Incidentally, in the light of the difficulties being encountered by the authorities in interpreting monetary statistics, it should be noted that difficulties brought about by financial innovation, and the effects of sharp movements in interest rates and prices on monetary aggregates, were not unique to the United Kingdom.

As for structural rigidities, Mr. Joyce noted, the recent depreciation in the effective exchange rate had helped to improve competitiveness in the non-oil sectors, but overall competitiveness remained lower than in most other industrial countries. Unless the decline were reversed, there might be a further depreciation of sterling that could be self-defeating if it set off renewed inflationary pressures. That the prospect existed underlined the need to encourage shifts of resources into investment and exports. He also welcomed the reduction in supply-side rigidities in labor markets, in capital flows and investment, and in public enterprises. Although underlying structural conditions seemed to have improved, significant rigidities still existed: continued high unemployment and a deteriorating trade balance at a time of buoyant domestic demand suggested that some of the unemployment might have become structural. As he had said during the 1982 consultation, the U.K. authorities might consider playing a much more active role in assuring realistic wage rates. In particular, efforts to contain public sector wage increases and excessive labor union demands should be encouraged.

To the extent that the recent gains in productivity had reflected the disappearance of economically unviable firms, the trend was neither unexpected nor undesirable, Mr. Joyce remarked. However, if the remaining firms and new entrants were to take advantage of increased competitiveness in ways that would reduce unemployment, the authorities would have to combine a noninflationary macroeconomic stance with measures to promote flexibility and profitability in industry generally. Government policies, including tax policies, that could lead to lower operating costs and the introduction of more advanced capital goods were essential.

The staff was correct in observing that protectionism had increased in the United Kingdom, Mr. Joyce observed. He would urge the authorities to resist such tendencies wherever possible and to discourage the use of nontariff barriers. After all, the success of the United Kingdom in maintaining or increasing its share in world trade depended upon the maintenance of a free, open trading system. That country above all had a great deal to lose if the system became unraveled because of protectionist measures taken by the authorities of the United Kingdom or the European Communities.

Mr. Jayawardena recalled that during the past several discussions for Article IV consultations with the United Kingdom, Executive Directors had welcomed the authorities' success under the Medium-Term Financial Strategy in fighting inflation and reducing structural rigidities, while expressing concern about the heavy costs of the operation in reducing output and employment as well as the impact of the MTFS on the rest of the world. The choice of desirable policy objectives had now become clearer, but little had occurred to allay Directors' earlier concerns. He agreed with the U.K. authorities that the basic design of the MTFS had been appropriate. Inflation and structural rigidities had been the main problems; tighter monetary and fiscal policies, accompanied by attempts to break down the structural rigidities in the economy, had been the priority decisions taken. Although slippages had occurred, he had been greatly encouraged by Mr. Wicks's statement that the authorities were firmly committed to the MTFS, despite the difficult economic environment.

A reduction in inflation and perhaps in long-term inflationary expectations, together with more moderate interest rates and public sector borrowing, encouragement of private sector activity, removal of wages and price controls, and other measures to create more competitive markets should have a strong long-term impact on resuscitating the long-ailing U.K. economy, Mr. Jayawardena noted. The authorities had persevered with their policies in difficult international circumstances and at considerable domestic and social costs in the form of higher unemployment and lower real incomes. As the staff had shown, the economy had shown some signs of emerging from the recession by 1982, but, since then, growth had been slow and induced largely by an upsurge in consumer spending. He hoped that expectations for a revival of investment, as described by Mr. Wicks would materialize, although he was not optimistic. On the other hand, the growth in productivity could be largely due to labor shedding. His main concern arose from continued difficulties in the fiscal and external areas and also from structural rigidities. Exports remained sluggish and U.K. market shares continued to dwindle, while imports grew; a shift in exchange rate policy appeared to have been ruled out as a remedial instrument. Meanwhile, protectionist pressures had intensified.

The experience of the United Kingdom showed that noninflationary and sustainable growth in mature economies could not be willed into existence by restrained monetary and fiscal policies alone; they should be accompanied by strong structural adjustment, Mr. Jayawardena said. In general, mature economies seemed to have grown sluggish over time, so that a strong revival of competitiveness and open trade was fundamental to their adjustment toward a noninflationary growth path. Unfortunately, such structural changes had been slow in coming in the United Kingdom.

The second question was how permanent the gains achieved so far would turn out to be, Mr. Jayawardena continued. It could be argued that the lowering of inflation had been caused largely by a conspicuously overvalued pound, which might have also led to the deteriorating performance in manufacturing and exports. If the economy continued to prove sluggish owing to poor competitiveness of exports, protectionist pressures were likely to intensify, and the momentum built up in eliminating structural rigidities was likely to slacken.

The United Kingdom had one of the major economies in the world and could, in concert with others, induce a world economic recovery that would benefit industrial and developing countries alike, Mr. Jayawardena noted. Hence, he attached great importance to the sustained recovery of the U.K. economy and was somewhat dismayed that a clear picture of firm recovery had not yet become apparent. The authorities should be encouraged to persevere in their efforts at dismantling long-standing structural rigidities, the major area of weakness. Overreliance on monetary policy to stabilize and promote growth, and inadequate attention to structural deficiencies, might lead to a recurrence of beggar-thy-neighbor policies such as those that had once nearly brought about a collapse of the world economy.

In conclusion, the U.K. authorities deserved commendation for their record in official development assistance and their support for multilateral lending institutions, Mr. Jayawardena observed. Countries in his constituency had benefited immensely from the highly concessional aid received from the United Kingdom, which they greatly appreciated.

Mr. Finaish considered that the economy of the United Kingdom had shown further improvement in 1983: the recovery had picked up, although the pace of growth had appeared to slow somewhat late in the year; inflation had continued to fall, reaching the lowest rates since the late 1960s; and productivity indicators had again risen. However, several areas of concern remained. Unemployment had continued to rise to over 12.5 percent, the highest rate among major industrial countries, with no decline foreseen in 1984. Moreover, doubts continued to be expressed whether the momentum gained by recovery up to the latter half of 1983 would prove sustainable.

The authorities had reaffirmed their adherence to the MTFS initiated in 1979/80, Mr. Finaish observed, with the control of inflation still the principal goal of policy. The staff considered that much of the progress achieved so far in bringing down inflation and reviving growth could be attributed to the success of the policies pursued within the MTFS. Nevertheless, the costs of that achievement in lost output and greater unemployment had been much higher than foreseen at the outset. A question that arose was whether those costs could have been mitigated by a broader mix of policies, such as one dependent less on generalized demand deflation and more on complementary measures aimed at the sources of cost-push and structural distortions.

The main question about the ongoing recovery was not so much whether it would continue but rather whether its recent strengthening trend could be sustained so that unemployment would begin to decline, Mr. Finaish continued. Several recent studies had taken the view that some easing of fiscal policy from the course laid down in the MTFS might be desirable in order to prevent the recovery from running out of steam owing to lack of growth in effective demand. Such a situation might arise if growth in demand, which so far had depended mainly on growth in private consumption, were not sustained by adequate growth in other sources of demand such as private investment and exports. Furthermore, with the present abundance of idle resources and the considerable reduction of inflation already achieved, a moderate fiscal stimulus might not be inflationary or undermine the credibility of the authorities' medium-term, anti-inflation, nonaccommodating policies.

By contrast, the staff on page 19 of SM/84/35 had taken the view that there was "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," Mr. Finaish went on. The possible effect of a fiscal stimulus on interest and exchange rates could be eliminated, or mitigated, if monetary growth targets were consistent with the fiscal stance. Furthermore, it was true that a sizable part of present unemployment stemmed less from a dearth of demand than from relatively high wage costs and low profitability, and it followed that the solution for such unemployment lay basically in continued moderation of wage demands and improvements in productivity. However, some analyses of unemployment in the United Kingdom considered that a significant component of unemployment was demand related. The authorities might find that component possible to tackle by assuring adequate growth in demand, which--given the present rate of unemployment--might be attempted without setting off higher wage claims. Some elaboration by the staff of its judgment on the stance of fiscal policy would be helpful.

Reducing the fiscal deficit had been an important, and necessary, part of the authorities' strategy, Mr. Finaish noted. An adjustment in the fiscal stance, if considered desirable for demand management purposes, should not come at the expense of medium-term fiscal sustainability or the overall balance between savings and investment. However, despite a severe recession, a sizable improvement in the fiscal balance had already occurred: in cyclically adjusted terms, the public sector financial balance was estimated to have improved by almost 8 percent of GDP between 1979/80 and 1982/83, shifting to an estimated surplus of about 3 percent of GDP.

That shift into surplus had been several times higher than the average change in the seven largest OECD countries over the same period, indicating that fiscal policy from 1979/80 to 1982/83 had been highly contractionary in the United Kingdom, much more so than in other major industrial countries, even though the recession in the United Kingdom had been one of the most severe. According to some analysts, the greater depth of the U.K. recession could be explained partly by the authorities' fiscal stance. Against that background, some--reportedly unintended--relaxation of the fiscal stance that had taken place in 1983 might not be regarded as a source of great concern but indeed as a corrective to the previous, extremely contractionary impact of fiscal policy. The staff noted that the relaxation of the fiscal stance had contributed to the strengthening of recovery in 1983 and did not appear to have had much of an adverse inflationary impact.

Although the authorities had had some notable success in containing the size of the fiscal deficit in the face of a recession--and although the actual deficit and the PSBR could be expected to fall further as the recovery proceeded--some changes in the structure of public finances underlying that achievement had been less in line with their intentions, Mr. Finaish observed. It was that structural aspect of fiscal developments, rather than a speedy further reduction in the size of the deficit, that perhaps deserved greater attention at present. The authorities had intended to narrow the deficit mainly by reducing public spending relative to GDP, but the actual reduction achieved had been brought about by an increase in the tax burden and by the sale of public assets, for spending had in fact increased relative to GDP. Moreover, the brunt of the efforts to contain the growth of spending had been borne by capital expenditures, which had declined to less than 5 percent of total spending. Of course, part of the increase in current spending had been a manifestation of automatic stabilizers at work, which would reverse themselves with the continuing upturn in economic activity. Nevertheless, some additional measures to contain growth in current spending would be needed in the course of recovery if the authorities wished to lighten the tax burden in the future and raise the share of capital outlays in total spending. Could the staff say whether the recently announced plans for the next three years aimed at increasing the share of capital outlays?

Declining public sector investment had been combined with declining private sector investment, so that total investment in the United Kingdom had fallen appreciably in recent years, though some pickup had been recorded since 1982, Mr. Finaish observed. The ratio of gross fixed capital formation to GDP was the lowest among major industrial countries. The decline in investment had been particularly pronounced in manufacturing, having fallen by over one third since 1979. As an adequate rate of investment was an important condition for sustained growth of output at a healthy rate, the decline in investment deserved greater attention in the authorities' medium-term planning.

Clearly, a durable improvement in the performance of the economy called for not only appropriate macroeconomic policies but also structural reform measures, Mr. Finaish said. Although several measures aimed at reducing structural rigidities and distortions had been taken during the previous few years, the staff had correctly noted that much more remained to be done.

Some of the structural measures had contributed to a pickup in productivity growth, which would have to be sustained since productivity in the United Kingdom remained relatively low, Mr. Finaish continued. However, it might be too soon to determine whether the recent improvements in productivity represented a rise in the trend rate of productivity growth. The staff noted that there was "no conclusive evidence that productivity gains had resulted from a reduction in the share of low productivity firms within manufacturing," although also noting that "the rise in productivity had been accompanied by rising unemployment and a shrinking in the size of the manufacturing sector." By contrast, in some other recent studies, at least a significant part of the rise in productivity indicators had been found to be related to less efficient units going out of business instead of reflecting an improvement in the efficiency of resources that continued to be employed. Indeed, a recent study by Professors Buiter and Miller had concluded that "the current productivity record of much of British manufacturing industry is like the cricket team that improves its batting average by only playing its better batsmen; as long as the tail-enders score some runs, however, it would surely be better to play them even if it does lower the side's batting average." Comment by the staff would be helpful.

To the extent that there had occurred a shutdown of less efficient capacity, Mr. Finaish went on, an important determinant of productivity growth in the future would be the use made of the resources thus released. So far, most of them remained unused, a development tantamount to a shift from a low-productivity use to a zero-productivity use. Only if such unused resources could be reabsorbed at or close to the productivity levels of surviving capacity would the recent gains in productivity prove to be sustainable in the longer run. A reabsorption of resources at a higher level of productivity would, however, be difficult to bring about without committing further resources to capital formation, a point that again served to stress the importance of maintaining an adequate level of investment.

With respect to the external sector, the staff had said that the present level of competitiveness might be inconsistent with external balance in the medium term and a growth rate that would allow some absorption of unused resources, Mr. Finaish noted. A further improvement in competitiveness was therefore desirable. The authorities preferred to achieve the improvement by further reducing the rate of increase of domestic costs. However, to the extent that such improvements were matched by similar ones in the United Kingdom's trading partners, as had happened so far, a further depreciation in the nominal exchange rate of sterling would seem unavoidable. It was relevant to note that the significant depreciation in the nominal exchange rate since 1981 had occurred without reversing the progress made against inflation.

He welcomed the greater attention paid by the staff to trade policy matters in the papers on the United Kingdom, Mr. Finaish concluded. The authorities had reaffirmed their commitment to an open trading system, but the recent expansion of protectionism, as reflected in the erection of more nontariff barriers, gave cause for concern. It appeared from Appendix VIII of SM/84/43 that the incidence of restrictions was greater on exports of developing countries. The staff had correctly noted the need for an early rollback of the various trade restrictions in the United Kingdom.

Mr. de Maulde said that he continued to admire the financial virtue practiced by the U.K. authorities. However, he believed that they could have made their policies even more efficient had they made them more comprehensive.

The medium-term perspective chosen by the staff struck him as the right way to deal with the present Article IV consultation, Mr. de Maulde continued. His only regret was that, contrary to the practice with other major economies, the staff had refrained from presenting its own forecasts for the main economic aggregates, relying instead on the forecasts made by the U.K. authorities. Did that mean that the staff's own forecasts were identical, that they diverged too greatly from those of the authorities, or that the staff had not prepared any forecasts of its own?

For the past five years, the U.K. authorities had been applying an economic strategy closely paralleling the standard recommendations of the Fund: strict monetary and fiscal policies had been accompanied by structural measures intended to restore a more flexible and competitive market economy, Mr. de Maulde noted. Having been somewhat protected from the second oil shock by virtue of its own oil producing capacity, the United Kingdom constituted a sort of textbook case showing the results of implementing the policies currently recommended by the Fund. The good news included a sharp decrease in the rise in retail prices from nearly 18 percent in 1980 to 4.6 percent in 1983. An emerging recovery of output growth, even if the strongest components of demand in 1983 had been household consumption and stockbuilding rather than investment or exports, was another piece of good news, as was the improved productivity in manufacturing.

On the other hand, Mr. de Maulde observed, industrial production remained quite weak, having risen by only 2.5 percent in 1983 from a low base. The rate of unemployment, which had reached 12.5 percent in 1983, remained unacceptably high, while the continued worsening of the non-oil trade balance was worrying. The authorities would have to solve those three problems in order to clear the way for noninflationary sustained growth in the medium term. As Mr. Wicks had said, his authorities were looking for further strengthening in the supply capacity and competitiveness of the economy to bring about such sustained growth.

There was large untapped potential for improvement in two areas, Mr. de Maulde considered. The first was investment: even if an upswing had been occurring since the summer of 1983, it was far from compensating for the huge drop registered during the preceding years, especially in manufacturing. In that respect, the emergence of a deficit in the trade balance for manufactured goods revealed the continued deterioration of U.K. industry: Chart 5 of SM/84/35--which illustrated long-term trends toward a decrease in export market shares and in the export profitability of manufactures--was quite sobering. In view of the importance of the U.K. economy for the rest of the world, particularly for the European Communities, it appeared urgent that that trend should be reversed. In that respect, he would like to stress the interest that the EC countries had in launching coordinated programs of investment, particularly in high-technology fields. He welcomed the recent decision of the U.K. authorities concerning aircraft construction.

A second area in which progress could be made was that of incomes policy, Mr. de Maulde remarked. Unfortunately, the present level of U.K. competitiveness was not consistent with medium-term equilibrium in the current account combined with appropriate growth. Furthermore, the depreciation of the nominal exchange rate entailed real inflationary dangers, and the rising trend in labor costs had become worrying. Those developments led him to consider that the lack of a real social consensus remained one of the major hidden weaknesses of the U.K. economy and that any effort to try to build up such a consensus through some form of incomes policy could yield substantial dividends, especially at the present time.

Regrettably, he was not in a position to congratulate the United Kingdom regarding its official development assistance efforts, Mr. de Maulde went on. The reduction in aid flows channeled through multilateral organizations, in particular IDA and regional development banks, had transmitted a most inopportune signal, one that he hoped that the authorities would reverse. In sum, the adjustment efforts being undertaken by the United Kingdom appeared both outstanding and incomplete.

Mr. de Groote observed that despite significant improvements, the United Kingdom was still plagued with substantial imbalances. The economy was in equilibrium, but one both suboptimal from the standpoint of employment and unsustainable in the medium term. Indeed, he doubted whether the policies being pursued by the authorities would fundamentally improve the economy over the next few years. Continued revenue from the oil sector could make possible a further expansion of the services sector, but it was not clear how such an expansion could be sustained once the oil sector began to shrink, especially if the manufacturing sector continued to shrink as well. Over the medium term, better prospects for expanding employment and maintaining external balance would require a larger contribution from manufactured exports, which in turn would require much higher competitiveness. He fully shared the staff's view that the present level of competitiveness was inconsistent with current account equilibrium in the medium term and with the rate of output growth necessary to increase employment. Appendix IV in SM/84/43 highlighted the role played by excessive wage increases in the poor profitability of enterprises during the previous ten years; the size of the wage gap indicated that a substantial adjustment would already be required to bring profitability back within a normal range. Although the growth in nominal wages had slowed, hardly any progress had been made in diminishing domestic costs compared with costs in the United Kingdom's main competitors. As noted by Mr. Finaish, the authorities should therefore place greater emphasis on exchange rate flexibility.

The staff had correctly observed that the depreciation of sterling by 18 percent during the past two years had occurred at a time of decelerating inflation, Mr. de Groote continued, and that there was thus ample room for a gradual and managed depreciation of sterling to a more sustainable rate. A rapid depreciation could occur in any event, once oil revenues began to fall, if no alternative export revenues were raised. Unless the authorities gradually undertook such a depreciation of the exchange rate, events might vehemently impose themselves once oil revenues started to fall and negative expectations began to affect the long-term value of sterling. The depreciation could then become uncontrollable, particularly as private external liabilities in sterling were about twice as high as gross official reserves. Moreover, the structural deficiency of U.K. manufacturing exports and the high import penetration in manufacturing, as shown in Appendix VII in SM/84/43, made it doubtful whether any meaningful adaptations could be achieved without exchange rate adjustments.

The Government intended market forces alone to determine the exchange rate, Mr. de Groote said. Yet the data presented in Table 1 of SM/84/35, Supplement 1 showed that by the end of 1983 the country's gross reserves expressed in dollars had fallen some 30 percent below the figure for the end of 1980, implying that the authorities had intervened sizably in the foreign exchange markets at times when the exchange rate for sterling had been depreciating. Through fiscal and monetary policies, the authorities indeed had the means of exercising strong influence on the exchange rate. Although for the moment they were still able to formulate policy without regard for external repercussions, because oil revenues assured external equilibrium, the eventual diminution in those revenues would increasingly force the authorities to adjust their policies to external requirements. For that reason, they would do well to undertake such an adjustment soon in order to avoid later abrupt changes that might prove disruptive of economic activity.

Making a specific comment on export projections, Mr. de Groote noted that during the last quarter of 1983, export volume had grown by some 3 percent on a yearly basis. More up-to-date information would reveal the precise extent of the improvement, but he wondered about the projection for non-oil export volume growth in 1984; it seemed somewhat on the high side, particularly as the United Kingdom sent only 16 percent of its exports to the United States, where prospects for growth were brighter than elsewhere.

He could agree fully with the staff's view on the sustainability of the exchange rate, but he had some difficulty in sharing its view on fiscal policies, Mr. de Groote continued. The staff was certainly correct that an improvement in economic activity had to be brought about by supply responses, which required higher profitability. An increase in domestic demand would certainly spill over in the external sector if the domestic economy were not in a position to respond to it. Such a possibility did not mean, however, that domestic demand should be further compressed; insufficient demand could prevent supply reactions from responding adequately. Therefore, at the moment there was no need to reduce the PSBR further; it was projected to drop to 2.4 percent of GDP in 1984/85, and any reduction would further weaken domestic demand. Accordingly, he would not share the staff's concern that a PSBR equal to 2.4 percent of GDP would put upward pressure on interest rates, unless domestic savings, particularly personal savings, fell any further. In any event, it was unlikely that savings would fall, because the present recovery was being built on an already sizable reduction in personal savings.

The U.K. authorities had sufficiently relaxed monetary policy to allow ample room for a recovery of output based on rising consumer demand, Mr. de Groote concluded. As in the United States, experience had shown the positive role that monetary policy could play in sustaining recovery. Despite the strong expansion in the real money supply, inflation had decelerated further, indicating that inflationary expectations had abated--a development in which the MTFS had played a crucial role. The authorities' decision to establish a framework for fiscal and monetary policies gave people confidence that sound policies would be pursued. The authorities should therefore minimize any deviations in the MTFS if they wished to maintain their credibility.

Mr. Laske endorsed the staff appraisal, which was almost identical to his authorities' own assessment of the U.K. economy. He greatly appreciated the general medium-term orientation of the economic policies being pursued. In former years, the relatively high degree of rigidity in various markets, especially in the labor market, together with government interference and regulation and deeply embedded inflationary expectations, had resulted in a disappointing performance of the economy, both internally and externally. It had become increasingly obvious that the authorities had to find new answers to those problems in order to address not only cyclical problems but also structural ones. Before the reorientation in 1979, the authorities had dealt with economic matters primarily within a short-term framework that had led to stop-and-go policies. With that historical background in mind, he welcomed the new medium-term framework for economic policy. In view of the profound maladjustment in the U.K. economy, the benefits of the new approach would not be reaped immediately; improvements might become discernible only after some delay. Therefore, Executive Directors had to exercise a certain degree of judgment in evaluating the present supply-oriented policies and the successes achieved so far.

Economic growth had resumed in the United Kingdom in 1981, Mr. Laske went on, but unfortunately only in the services and oil sectors. Industrial production, especially in manufacturing, had been virtually stagnating, as reflected in the trade and current account balances. Much of the increase in aggregate demand had been concentrated on foreign goods, indicating intensified import penetration of the domestic market. In 1983, for the first time since it had begun to industrialize, the country had registered a deficit on trade in manufactured goods. He noted however from Mr. Wicks's statement that there were some signs pointing to a spillover of demand from the consumer goods sector to the capital goods sector. Such a spillover would be welcome because it would offer prospects for a more balanced pattern of growth.

Better performance in manufacturing was needed, first of all, to alleviate high unemployment in the United Kingdom, Mr. Laske commented. The U.K. authorities had expressed the hope that an expanding services sector would ease pressures on the labor market, but the hope had so far failed to materialize. In any event, could an expansion of services serve as a rapid and complete substitute for the shrinking manufacturing sector, especially when a great many of those currently unemployed had once worked in manufacturing? The experience of the United Kingdom, like that of other oil producers, seemed to show that increasing revenues from petroleum could prove to be a mixed blessing: the additional income, which was likely to taper off within the next 10-15 years, might well be having a detrimental impact on incentives for structural change and thus be undermining the longer-run health of the economy. As Mr. Wicks had stated, the prospects for an eventual weakening of the current account position might be mitigated to the extent that the authorities used oil revenues to acquire foreign assets that would provide longer-lasting inflows of liquidity. Nevertheless, the evolution of the current account in 1983 and so far in 1984 indicated that oil revenues were being used primarily to finance imports of goods and services.

The real appreciation in the exchange rate of sterling, resulting from oil export revenues during the past six years, had not been matched by compensating gains in productivity, Mr. Laske remarked. A loss of competitiveness vis-à-vis the main trading partners had ensued, a loss offset only partly by the recent depreciation of the effective exchange rate. He agreed with the authorities' view that competitiveness should be re-established mainly by lower growth rates in domestic costs and prices rather than by deliberate actions to adjust the exchange rate. The authorities nonetheless faced the dilemma that exports from the relatively small oil sector were boosting the exchange rate and imposing on the remainder of the economy a need for adjustment, which a few years hence might prove to have been going too far or in the wrong direction.

Public sector finances in the United Kingdom were influenced by the likelihood that oil revenues would shrink and that the population would age, changes that would widen public sector deficits considerably unless compensating changes occurred, Mr. Laske observed. The authorities would therefore have to find means of economizing on public expenditure. As the staff had mentioned, consideration could be given to controlling the costs of medical care and pensions. Options that would rely more on private sector activity in health care and retirement benefits could also be considered, and the solutions found might eventually bring about a better use of scarce resources. He had noted in that respect that the Government had been rather successful in reducing the size of the civil service.

On the revenue side, the authorities should consider adapting the tax system to strengthen the industrial sector, not only to improve the profits of enterprises, but also to furnish incentives to more productive investment, Mr. Laske remarked. In addition, some tax relief might be helpful for wage earners who took home scarcely more than what they might receive in unemployment compensation. At the same time, such tax relief might well serve as an inducement to seek gainful employment. He was however making those comments on the assumption that any tax relief measures would not lead to a deterioration in the overall budget position, pushing up the Government's financing requirements in the process. Therefore, he was pleased to note in SM/84/35, Supplement 1 that revenue had recently increased handsomely, and that consequently a PSBR lower than the revised projection might not be out of reach. He hoped that a decline in the PSBR would allow the authorities to come to positive decisions on lowering taxation. Recently, the conduct of fiscal policy had been affected by certain slippages. He felt heartened by the authorities' assurances that those trangressions had represented only temporary deviations from the trend lines already decided upon.

In the past year, monetary policy had been quite successful in compressing the rate of inflation and diminishing inflationary expectations, Mr. Laske considered. The simultaneous establishment of more than one monetary target might however impair the public's understanding of the official strategy. He would thus encourage the authorities to consider returning to the practice of setting only a single monetary target. He had noted with satisfaction that the growth of monetary aggregates had been significantly reduced.

Although the outlook continued to be clouded by uncertainties, the policies followed by the authorities during the past two years had brightened the outlook considerably, Mr. Laske concluded. Clear signs had emerged that productivity would improve and that the labor situation would relax somewhat. Further progress could certainly become possible if wage pressures remained moderate; management and organized labor appeared to have developed a better understanding of some necessary adjustments in the economy and consequently of the authorities' objectives. Their understanding needed to be firmly underpinned by policies designed to keep the inflation rate down and to restrain the financing needs of the public sector, so that the private sector could invest and expand. He was confident that the U.K. authorities were following such a course.

Mr. Polak recalled that the results of the Medium-Term Financial Strategy adopted four years previously had already become apparent at the time of the 1982 Article IV consultation. As he had said on that occasion, the intermediate aims of the MTFS with respect to inflation, the budget, interest rates, profits, and productivity had to a substantial degree been attained. Mr. Wicks's observations on the importance that his authorities attached to continuity in policy implied that the Fund's annual consultations with the United Kingdom would increasingly be concerned with the application of policy rather than with a review of new approaches.

One of the main objectives of policy since 1979 had been the removal of rigidities in the various markets, particularly the labor market, Mr. Polak continued. After all, between 1973 and 1979, productivity had risen at the comparatively slow annual rate of only 1 percent. The present authorities believed that major structural changes were needed in order to revive the private sector and make it competitive. The recent rise in productivity could be regarded as one of their greatest achievements. However, he found it difficult to determine from the staff papers what structural changes had taken place and what further changes were expected. Did the authorities have any objectives with regard to maintaining or changing the comparative weights in the economy of various industries? Did they intend the manufacturing sector to be expanding its share? If so, the trend set forth in Table 5 of SM/84/43 was discouraging, for it indicated that investment in manufacturing was still declining. If the authorities intended manufacturing to account for a smaller share of the economy, they might be encouraged by the recovery that had apparently begun in investment in plant and machinery outside the sector. Nonetheless, the main increases in investment so far were concentrated in housing rather than in productive capital formation.

Despite the great importance of structural change, the staff papers provided only skimpy information on the economic structure of the United Kingdom, Mr. Polak noted. Moreover, SM/84/43 did not provide the standard figures for area, population, GDP per capita, or working population. Again, the staff had included a multitude of rates of change in several variables, but few absolute figures or shares of totals. For instance, the staff simply noted that the labor force had shrunk but that employment had shrunk even more; it would be interesting to look at the actual figures. As it was, he had difficulty in detecting any structural changes that might already have been taking place, for lack of a breakdown by industry, either for GDP or for employment. Investment had increased most in construction, but what share did construction have in total investment? Furthermore, the useful concept of non-oil GDP, which the staff had included in earlier years, seemed to have disappeared. Accordingly, there was no way to reconcile the good news in Chart 1 of SM/84/35 that the rate of increase in U.K. output had been higher than that of the average of six other major industrial countries during most of the past four years, with the distressing news in Chart 2 that, during the same period, U.K. industrial production had fallen by 10 percent compared with that in the other six countries.

On another point, Mr. Polak continued, a crucial element was certainly profitability in manufacturing. Table 44 in Appendix IV of SM/84/43 compared the rate of return on capital with the cost of capital: from 1963 to 1972, there had been a 5 percent positive margin between the two that must have been conducive to investment; from 1973 to 1983, by contrast, there had been a slight negative margin. Table 44, however, said nothing about the question whether any improvements had been registered during the past few years. The point was relevant because real wages had continued to rise, even though the rate of unemployment had been rising as well.

The authorities deserved commendation for having persevered with the MTFS, Mr. Polak commented. Mr. Wicks had been correct in noting that it was central to create correct expectations and to solidify credibility in the MTFS. The authorities would however have to correct deviations in policy in order to return to the medium-term target ranges. In early 1983, there had been major deviations; for instance, domestic and credit expansion had remained high, liquid assets having increased by 14.5 percent during the year, compared with a rise of about 17 percent in each of the two preceding years, when inflation had been raging much more virulently. The recent increase in liquid assets appeared to have been due to persistently strong private demand for credit, together with a temporary overshooting of the target for the PSBR. In spite of a loss of liquidity through the balance of payments, M-3 had just barely remained within the target range, so that monetary growth had expanded at a rate well above that of the expansion of money GNP. Following that experience, the authorities would do well to keep the growth of the money supply in 1984 comfortably within the target range of 8-10 percent. The improvement in the PSBR should make achievement of that target feasible without any increase in interest rates. He supported the authorities' intention to bring the PSBR for 1984/85 down to the original target of 2.5 percent of GNP. He agreed with the staff that the definition of the PSBR should continue to exclude the sale of government assets, which should be seen as a means of financing the deficit rather than as a source of revenue.

The staff report was not conclusive on whether competitiveness was adequate, Mr. Polak went on. On page 13, the staff said that the U.K. authorities had not expressed a view on the matter, but the reference on page 12 to their opinion that the United Kingdom's share of export markets should stabilize seemed to suggest that they were not particularly concerned. Perhaps Mr. Wicks could clarify the point. The staff's view seemed to be that competitiveness was not high enough to permit both a sustainable external position and a decent rate of growth; the main argument brought forth was that the economy had not yet completely adjusted to the real appreciation of sterling since 1978. However, sterling had ceased to appreciate some three years previously, and since then had been continuously depreciating in real effective terms. If there did exist a long lag in the effect of the competitive position on the trade position, as the staff correctly assumed, then major effects on the economy had to be still in the pipeline from the most recent real effective depreciation of sterling. In that connection, the staff had paid too much attention to what it called the "worsening" of the trade balance. In fact, until 1980, the United Kingdom's trade balance had been consistently negative for longer than a century, with a surplus in invisibles balancing the current account. The emergence of petroleum as a major export had produced in the short run a positive trade balance, but it was hardly surprising that the increasing importance of that commodity would lead to a downward adjustment in the country's balance on other tradable goods.

He agreed with the staff and the U.K. authorities that any further increase in competitiveness that might be required--a matter still open to interpretation--should be encouraged by domestic measures rather than by a further depreciation of the exchange rate for sterling, Mr. Polak continued. In 1983, import prices had risen by 8 percent, and the inflation rate seemed stuck at about 5 percent. He remained unconvinced by the staff's argument that, because the depreciation of the past two years had not reversed the downward trend in domestic inflation, the limits to any further noninflationary depreciation had not yet been reached. The authorities ought to continue their relatively stringent monetary and budget policies, as recommended by the staff, in order to make it less likely that the market--acknowledged by the authorities as the sole judge of the correctness of the exchange rate--would bring about an unwarranted depreciation of the currency.

Mr. Hirao noted that the economic strategy put in place in 1979 had begun to produce favorable results: inflation had decelerated, and economic expansion had resumed. The prospects for 1984 were for continued steady growth with no reacceleration of inflation. The authorities were to be commended for having steadily implemented the policies responsible for those impressive results. The progress achieved so far in the real sector would contribute to making possible a revival of private sector activity. Encouraging prospects for investment and enhanced growth in productivity did seem to indicate that conditions had improved.

However, the strong recovery in domestic demand had not yet been fully reflected in higher domestic output, Mr. Hirao considered. Consequently, the trade balance had deteriorated, with trade in manufactured goods recording a deficit for the first time in the twentieth century. In addition, the rate of unemployment had remained high, with only a small decline foreseen for the coming year. In view of the uncertainties associated with the prospective slackening in oil production, methods to restore the level of competitiveness would have to be explored.

The authorities should adhere to the Medium-Term Financial Strategy, Mr. Hirao remarked. Deviations from medium-term goals should be allowed only in exceptional circumstances. He thus welcomed the authorities' intention to return to the medium-term target for public sector borrowing in 1984/85 and to hold public expenditure constant in real terms during the next three years. He also welcomed the efforts being made to contain spending by local authorities; the act introduced in Parliament to give the national authorities the power to limit local tax increases should be approved in order to enhance control over local spending. Furthermore, steadfast efforts to reduce budget deficits would further enhance the authorities' credibility, help to diminish inflationary expectations, and sustain progress in reducing interest rates, thus contributing to creating a favorable environment in which private investment could be further encouraged. The conduct of monetary policy--which continued to aim at attaining price stability, taking account of various monetary aggregates--seemed broadly appropriate and would have to be adhered to in coming years.

He shared the view that insufficient flexibility in determining wages, the slow adjustment to structural changes in industries, the low mobility of labor, and inadequate work incentives had played a far greater role in the rise of unemployment than had any insufficiency of aggregate demand, Mr. Hirao said. Therefore, resorting to a more expansionary fiscal policy would not be the right solution: as the staff had said, such a policy would, at best, produce only temporary gains in output and employment and would prove counterproductive in the medium term. The authorities' efforts to continue to try to slow the growth of public spending and to reduce taxes remained praiseworthy. He agreed with the staff that remedies for high unemployment, such as reducing employment costs and improving work incentives, should be explored. Like Mr. Laske, he favored a reduction in the tax burden, particularly for workers whose earnings were only slightly above the amount of unemployment compensation.

As the U.K. authorities and staff had maintained, Mr. Hirao continued, macroeconomic policies alone were not enough to assure better performance. He welcomed the emphasis on encouraging structural flexibility through market forces; the authorities had done much to enhance economic flexibility and efficiency by deregulating industries and promoting competition in the labor and goods markets. Preserving and expanding the openness of the trade system were particularly important. Fortunately, the authorities were committed to maintaining an open trade system, and he firmly supported the objectives of the present rollback exercise. As the staff had said, removing barriers to trade would, over time, prove advantageous to the United Kingdom by heightening efficiency and lowering costs and prices, developments that would be essential in restoring competitiveness. In closing, he fully shared the principles underlying the authorities' present policies, which emphasized the importance of initiative and vigor in the private sector rather than dependence on the Government.

Mr. Nimatallah commented that the reasonably strong recovery in the United Kingdom was encouraging both for that country and for its trading partners. Prospects for further growth in 1984/85 were more favorable than for some time. However, unemployment remained high, manufacturing had not yet recovered from a substantial loss of competitiveness in the late 1970s, and the non-oil trade balance had weakened, particularly in exports of manufactures. Because those problems were deep-rooted, they could not be solved overnight; the authorities therefore continued to focus on structural adjustment over the medium term. They had established a credible framework of financial restraint on which to build, and it would have to be maintained if they were to achieve their longer-run objectives. He therefore agreed with Mr. Wicks and the staff that a more expansionary fiscal stance would be counterproductive at a time when the authorities wished to shift resources into investment and exports. They had made commendable progress in reducing the public sector borrowing requirement as a proportion of GDP, and were to be congratulated for their intention to keep public spending broadly constant in real terms until 1986/87. Although it would not be easy, the authorities should have room to reduce the burden of taxation, which, as Mr. Wicks had said, remained too heavy, particularly in the corporate sector.

He also agreed with the staff that monetary policy should not be relaxed, Mr. Nimatallah said. After all, the growth in the money supply during recent months had allowed considerable scope for a further recovery in output. As competitiveness depended upon continued moderation in wage settlements, he found it disappointing that average earnings in 1983 had risen at a rate well above that of inflation. He fully supported the authorities' efforts to make the labor market more responsive to market forces by eliminating restrictive practices and improving labor mobility.

For a major trading country like the United Kingdom, the exchange rate could be a useful tool, particularly in promoting and diversifying non-oil exports during the next few years, Mr. Nimatallah observed. The need for an active exchange rate policy would depend in great measure on the authorities' success in reducing domestic costs. In the longer term, a judgment about the correct exchange rate depended critically on where the United Kingdom's comparative advantage lay. The authorities' inability to resist protectionist pressures ran counter to the principle of comparative advantage and was inconsistent with seeking an efficient allocation of resources. He therefore encouraged them to dismantle trade barriers and return to free trade.

It was disappointing that development assistance provided by the United Kingdom had fallen as a percentage of GDP in 1982, Mr. Nimatallah said. He hoped that the percentage would increase, as planned, in coming years. Official development assistance represented one important way, together with free trade, in which the United Kingdom could make a direct contribution to the world recovery, from which the country itself had much to gain.

Mr. Ismael commented that the U.K. authorities had made considerable progress in encouraging a moderate rate of economic growth and in bringing down the rate of inflation. They needed to reduce the public sector deficit and alleviate some structural problems. He supported their intention to reduce the public sector deficit gradually, not only to lower interest rates in the short term, but also to make public finances secure against a future crisis when oil revenues would fall and the demand for welfare payments would rise. For those reasons, steady progress should be made in reducing the PSBR, which in 1983/84 had risen to 3.7 percent of GDP. In the absence of a policy change, the target of 3 percent of GDP for 1984/85 might not turn out to be achievable: the authorities should introduce measures to reduce the public sector deficit.

In 1982/83, spending by the Central Government had accounted for about 50 percent of GDP, Mr. Ismael noted; including local governments and public corporations, public sector spending had accounted for more than two thirds of GDP. The figures suggested a need for a reduction in the share of government in GDP in order to achieve the authorities' medium-term fiscal objectives. Indeed, measures were already being taken to privatize certain public sector enterprises, but they might prove to be inadequate.

As little was being spent in the United Kingdom on research and development, a number of industries were increasingly obsolescent, Mr. Ismael remarked. It was disheartening to note from Table 5 in the report on recent economic developments that, after several years of slow growth of investment in manufacturing, investment had actually declined by 14 percent in 1980, 25 percent in 1981, 8.5 percent in 1982, and a further 5.5 percent in the first half of 1983. Profitability in industry continued to be low. Available information suggested that the impetus for economic growth in the U.K. economy in the past few years had come from private consumption and stockbuilding rather than from fixed investment. With the world economy on the threshold of a recovery, investment in the United Kingdom should be directed toward restructuring export industries, so that the country might maintain its share in foreign markets. The staff had correctly suggested that further structural measures would turn out to be needed in a number of areas in order to improve economic efficiency and promote new investment.

In the absence of a buoyant and competitive industrial sector, and given the high rate of unemployment, it was understandable that the U.K. authorities had yielded to pressures for protection in a number of industries, Mr. Ismael concluded. He would urge the authorities to roll back the protectionist measures already introduced in order to promote greater efficiency, lower prices, and an open international trading system.

Mr. Arias endorsed the staff appraisal, noting that the U.K. authorities had been successful on the whole in adjusting economic policy so as to propel the economy toward a sustainable recovery. Inflation and interest rates had declined, while productivity and profitability had increased despite a worldwide recession, and despite the complex difficulties experienced at home in recent years. The authorities were to be commended for having re-established credibility in U.K. economic policy.

The public sector borrowing requirement had declined noticeably as a proportion of GDP, but total public spending had again begun to climb, Mr. Arias went on. The authorities had no doubt permitted it to do so because national income had been rising as well, owing to the coming on stream of flows of oil from the North Sea. Since the Medium-Term Financial Strategy envisaged reductions in the budget deficit, what measures were the authorities planning to halt the upward trend of public spending? Any relaxation in fiscal policy would lead to some monetary expansion, as had occurred in 1982, although he hoped that the authorities would monitor developments closely to avoid any resurgence of inflationary pressures. Incidentally, the staff papers did not make it clear how the authorities intended to manage monetary policy; perhaps Mr. Wicks or the staff could provide more detailed explanations.

Protectionism in the United Kingdom had increased during the past year, Mr. Arias stated. The authorities should try to avoid any further increases. What cutbacks in protectionism could be expected during the next fiscal year? As Mr. de Groote had pointed out, the medium-term scenario for sustainable growth had to be based on a rise in exports of manufactures, yet the recent improvement in profitability had not been large enough to allow industries to export more. Finally, he welcomed the intention of the U.K. authorities to increase official development assistance during the coming fiscal year.

Mr. Mtei expressed broad agreement with the staff appraisal. The authorities deserved to be commended for the progress achieved, particularly in reducing inflation and interest rates, thus paving the way for an expansion in output. The real GDP growth rate of 3 percent in 1983 had reflected improved performance, and the favorable prospects for 1984 indicated that the recovery might well be durable. Although a number of exogenous factors had contributed to the improvements, they had primarily been a result of an appropriate mix of monetary and fiscal policies. However, the impetus to aggregate demand, coming mainly from private consumption, had been financed largely by a drawdown in savings, the savings ratio having declined from 12 percent in the first half of 1982 to 8 percent in the second half of 1983. Should the decline continue, it could endanger the durability of the recovery in the medium term, particularly when the present capital stock approached capacity. An increase in the propensity to consume could have more serious short-run implications for employment and the balance of payments if domestic production failed to respond suitably to the shift in disposable income in favor of consumption. In fact, such a shift might already have taken place: in 1983, imports had risen by 5.2 percent, compared with a rise of only 3.1 percent in 1982 and a decline of 2.5 percent in 1981. In the first half of 1983, imports relative to GDP had risen by 1.3 percent.

Another weakness had been the disappointing performance of non-oil exports, particularly of manufactured products, Mr. Mtei said. Despite the rise in productivity, the United Kingdom had incurred a deficit on trade in manufactured goods for the first time in generations. The impact of that unfavorable evolution in the structure of traded goods went well beyond the worsening of the country's balance of trade from a surplus of £2.1 billion in 1982 to a deficit of £1 billion in 1983 that was projected to widen to £2.5 billion in 1984. The growing deficit could damage prospects for growth in the medium term, and its implications for employment could be even worse. As the staff had said, supply rigidities in industry caused by a loss of competitiveness might have contributed to the rise in unemployment. On the other hand, the fall in competitiveness might have been attributable to an appreciation in the exchange rate, but it was not clear whether structural rigidities outside the labor market had also contributed to the fall in competitiveness. To the extent that technological and institutional rigidities were widespread, the authorities might have to widen the scope of their supply-side policies to include the labor market.

The authorities' efforts to promote a properly functioning labor market might well contribute to improving competitiveness in industry and reducing employment in the long run, Mr. Mtei continued. At present, however, an unemployment rate as high as 12.5 percent deserved prompt attention by the authorities, not only because of the loss in output that the rate reflected but also because of social considerations. After all, the underlying objective of economic growth in any country had to be the welfare of the people.

At a time of rising unemployment, falling competitiveness, and worsening trade balances, protectionist pressures became difficult to resist, Mr. Mtei noted. Nevertheless, despite some temporary benefits, protectionism would lead only to further losses in competitiveness, less efficient allocation of resources, and a premature end to the economic recovery. He had therefore been pleased to learn from Mr. Wicks that the U.K. authorities were committed to maintaining a free trading system and intended to roll back existing protectionist measures. He hoped that they could take positive steps in that direction as soon as possible.

Financial assistance from the United Kingdom and other industrial countries had an important role to play in promoting economic development in developing countries, particularly the low-income ones, Mr. Mtei concluded. The decline in the assistance provided by the United Kingdom from 0.43 percent of GDP to 0.37 percent was indeed unfortunate. He would urge the authorities to meet and exceed the goal of increasing official development assistance by 8 percent in 1983/84 and by 5.5 percent in 1984/85; the country was still far from attaining the target of 0.7 percent of GDP set by the United Nations.

Mr. Tvedt observed that the U.K. authorities had been successful in reducing the inflation rate and interest rates, as reflected by renewed confidence in the economy, a major reason for the growth attained during the previous two years. However, under the new policy approach there had occurred a sharp rise in unemployment, which still showed no sign of declining, although the prevailing rate of growth of GNP in the United Kingdom was well above the European average. Moreover, as pointed out by the staff, the upswing in 1983 might have been partly attributable to "temporary deviations of financial policies from their assigned paths." He did not believe that those deviations had had any detrimental effects on the U.K. economy. On the contrary, the effects had been positive both for the United Kingdom and for its trading partners.

With a stricter monetary policy in place, the rate of increase in the GDP deflator had been slowed substantially, leaving greater room for an expansion of real output, Mr. Tvedt went on. Owing to improved monetary discipline, interest rates had declined, although they might have been temporarily pushed up during parts of 1982 and 1983 by concerns about the exchange rate. In addition, the decline in interest rates had been associated with a decline in the PSBR and with a slower pace of growth in the money supply. He agreed with the U.K. authorities that a decline in domestic interest rates would have a positive effect, especially if it were the result of a lowering of the PSBR by the authorities. One difficulty was that, in spite of the declining trend in the exchange rate, the country's competitive position was so weak that it might jeopardize the external economy in the medium term. A somewhat more expansionary monetary policy might help to lower interest rates and cause the external value of the pound to slide but it might also hamper the fight against inflation. Therefore, in practical terms there appeared to be little scope for an easier monetary policy, or for a different mix of fiscal and monetary policies, unless the long-term targets for the economy were altered. He agreed with the authorities and the staff about the necessity of furthering structural adjustments on the supply side, especially within manufacturing.

In the past 30 years, Mr. Tvedt noted, the United Kingdom's share of manufactured exports in the world market had fallen from 22 percent to 6 percent. The balance on trade in manufactures, which had traditionally shown sizable surpluses, was showing a deficit. According to econometric evidence presented in SM/84/43, that deficit could in part be explained by a relatively low income elasticity of demand for U.K. manufactured exports. Thus, the income elasticity of demand in the United Kingdom for manufactured exports from the rest of the world was twice as large as the income elasticity of demand in the rest of the world for manufactured exports from the United Kingdom. Moreover, while the ratio of manufactured imports to home demand had stood at 17 percent in the late 1960s, it had reached 28 percent by the early 1980s. Against that background, it appeared imperative to improve the overall economic performance of manufacturing industries. In particular, he agreed with the staff that the present level of competitiveness was probably too low to bring about a rate of growth that would allow for some reabsorption of unused resources either in the production process or in the labor market. According to Mr. Wicks, a redistribution of productive capacity from the traditional manufacturing sector to newer industries was already taking place. It should be furthered if the United Kingdom were to take advantage of the emerging recovery both in the domestic market and in foreign markets.

From both an international and a national point of view, it would be desirable to avoid policies that led to further reductions in capacity utilization and employment, Mr. Tvedt considered. He agreed with the staff that a further reduction in the size of the manufacturing sector might make it difficult for U.K. producers to increase market shares at home and abroad as the international upturn gathered momentum. As the United Kingdom was a traditional free trader, he had become concerned about the recent rise in protectionism. He had however been pleased to learn from Mr. Wicks that the authorities were maintaining their traditional support for an open trading system. He therefore hoped that they would work more strenuously for abolishing trade restrictions within the European Communities.

The U.K. authorities forecast that GDP would grow by 3 percent in 1984, although other forecasting institutions, notably the OECD, were predicting a lower rate, Mr. Tvedt continued. The U.K. authorities expected a further decline in the savings ratio and thus stronger consumer demand. It was interesting to note that while the savings ratio had risen steadily throughout the 1950s and had remained at 8-9 percent through the 1960s, it had moved upward again in the 1970s, peaking in 1980 at nearly 16 percent. Since that time, the ratio had again declined to 8 percent. Differences regarding the future direction of the savings ratio were related to differences about the impact in 1984 of the 1982 elimination of hire-purchase control and the lagged influence of the comparatively low inflation rate of recent years. The OECD believed that the effects of those two factors had already been more or less exhausted; the U.K. authorities appeared to believe that they were still capable of leading to a further decline in the savings ratio in 1984.

Relatively stable economic growth in the United Kingdom during the past two years had been induced primarily by a strengthening of private domestic demand, Mr. Tvedt concluded. If, however, private demand should turn out to be weaker in 1984 than the authorities expected, a temporary stimulus to demand, directed toward both investment and consumption, ought to be considered. For reasons of investment activity in the United Kingdom and of future moderate upswings in Western Europe, it was imperative that economic growth in 1984 should be at least as rapid as the official forecasts estimated. Finally, like other Directors, he regretted that official development assistance from the United Kingdom was likely to decrease again in 1984.

Mr. Senior shared the staff's appraisal of the U.K. economy. The authorities were to be strongly commended for the turnaround that their policies had induced in the underlying trends of the economy. Since 1979, the policy actions carried out, together with some exogenous factors such as flows of North Sea oil, had brought about a great improvement in the comparative growth performance of the United Kingdom and other industrial countries. Chart 1 in SM/84/35 showed that, until 1979, the rate of growth of real GDP in the U.K. economy had oscillated around a trend only about half as great as the one around which the rate of growth of the six other major countries had oscillated. At the same time, the rate of inflation in the United Kingdom had tended to be much higher and also more variable than the average inflation rate in other major countries. Since 1979, those trends had been reversed, and the performance of the U.K. economy in keeping up growth and keeping down inflation had become better than in other major industrial countries.

He agreed with Mr. Wicks that the authorities had maintained their policies under the Medium-Term Financial Strategy, Mr. Senior continued. Steady implementation of those policies was essential for the success of the authorities' strategy, as demonstrated by their intention to return to the target for the financial performance of the public sector contemplated in the medium-term program. The Government had correctly understood that expectations played a large role in macroeconomic adjustment and that reactions by economic agents to official policies depended upon the credibility that such policies might have. Recently, inflationary expectations had abated, so that real as well as nominal earnings had risen.

Most disturbing was the persistence of high unemployment, Mr. Senior considered; so far it had responded hardly at all to the high rate of growth. He agreed with the staff and Mr. Wicks that the continued rise in real wages might have discouraged new hiring. He would add, however, that changes in the shape of the demand side of the labor market had also contributed to the high unemployment. In other words, shifts in the sectoral distribution of demand and the allocation of resources associated with the coming on stream of North Sea oil, in conjunction with other technical developments, might have reduced the elasticity of the demand for labor. He did not wish to deny that current wages and the exchange rate were both so high that the competitiveness of U.K. non-oil tradable goods was too low to bring about full capacity utilization in the sectors that produced those goods. In any event, he joined with other Executive Directors in inviting the staff to explain the reasons behind the disappointing evolution of employment.

In sum, Mr. Senior concluded, the U.K. economy was experiencing faster growth and slower inflation than a few years previously. Increases in productivity had been made possible by a better allocation of investment resources. One possible cause of the disequilibria that did persist might be that the shift in policy since 1979 had set in motion many slow-working forces whose full effects would still take time to be transmitted throughout the economy. In addition, some major rigidities that continued to exist in the labor and capital markets were preventing a less costly process of nominal disinflation. On the whole, however, the approach followed by the authorities was proving successful.

Mr. Morrell endorsed the conclusions contained in the staff appraisal. Notwithstanding some shortcomings in the implementation of the Medium-Term Financial Strategy, the authorities had succeeded in reducing inflation and interest rates as well as improving corporate profitability and national competitiveness. Further progress would ensure that the U.K. economy retained the ground gained so far. He agreed with the staff that it was too early to conclude with certainty that the authorities had laid the foundation for sustained noninflationary growth, but he hoped that they would follow a consistent policy enabling the private sector to plan with some assurance that the recovery under way would strengthen and endure. There were already signs that exports, and to a lesser extent investments, were contributing to a more broadly based pickup in demand.

The latest monetary and fiscal data dispelled some of the concern that the staff had expressed in SM/84/35 about the direction of financial policies, Mr. Morrell went on. The authorities would need to minimize further slippages if they were to achieve policy objectives and maintain confidence in them. A disappointing feature of the Medium-Term Financial Strategy had been the inability of the authorities to reduce government expenditure, which as a proportion of GDP remained above the 1979/80 figure because of the increase in the overall tax burden, with associated disincentive effects. Another disappointing feature was that such expenditure restraint as had been imposed had fallen disproportionately on capital expenditure.

In fiscal year 1984/85, the authorities intended to return to the target for the public sector borrowing requirement, which had not declined during the previous two years, Mr. Morrell said. They also intended to hold spending broadly constant in real terms for the next three years, which as the economy expanded further would allow public expenditure to diminish as a proportion of GDP, providing scope for needed tax reductions. Given the need to reduce social expenditure over the medium term and eventually to make room for the effect of demographic trends on such expenditure, would it be enough merely to stabilize government spending in real terms? He supported further consideration of proposals for encouraging greater involvement by the private sector in providing some social security benefits.

It was crucial for the future competitiveness of manufacturing and for better employment prospects that the authorities should take steps to increase labor mobility and reduce rigidities in the labor market, Mr. Morrell considered. The coexistence of large gains in real wages with high rates of unemployment indicated how prevalent such rigidities were. Although there might be some scope for adjusting the exchange rate on grounds of competitiveness, further improvements in cost competitiveness and especially in unit labor costs would become necessary later in the 1980s, as the cushioning effect of revenues from North Sea oil declined.

Like a number of Executive Directors, he welcomed the attention given by the staff to the need to reduce protection, including agricultural protection, Mr. Morrell concluded. Recent developments in the Common Agricultural Policy (CAP) of the EC had confronted traditional exporters of U.K. agricultural products not only with greatly reduced access to markets in the EC, but also with increasing competition in third-country markets against products supported by export subsidies from other EC countries. The budgetary costs of such subsidies to those EC countries had of course been considerable.

Mr. Donoso observed that the authorities of the United Kingdom had brought down the rate of inflation in order to create a better environment for growth and to increase the competitiveness and flexibility of the economy. Legislation had made markets more competitive, and many public enterprises had been privatized. Under the Medium-Term Financial Strategy, the authorities had set limits to the public sector borrowing requirement and to the growth of monetary aggregates, limits that implied a major fiscal and monetary adjustment. The authorities' determination in implementing consistent policies had meant that the economy was already receiving the benefits of their efforts. The slowdown in the rate of price inflation had become the most visible success of the MTFS.

The recession was coming to an end, Mr. Donoso went on: by the end of 1983, GDP had just reached the figure in real terms at which it had stood four years previously, although the rate of unemployment remained high. Distortions in relative prices persisted, as a consequence of rigidities in wage determination. In many sectors, profitability continued to be low. Fortunately, the increase in revenue from North Sea oil had coincided with the most difficult period of the authorities' adjustment program and had partly offset the fall in GDP, which, in the absence of oil revenue, would have been even more pronounced. The authorities knew that it was impossible to stabilize the economy without making sacrifices in production and employment, and they had chosen to endure a difficult period in the hope of obtaining future benefits. He was glad that they had come closer to achieving the objectives of the program and assuring a satisfactory recovery of the economy.

Greater price stability had allayed uncertainties relating to the profitability of investments and had thus facilitated economic growth, Mr. Donoso remarked. Privatization of public enterprises had also made the sectors in which they operated more attractive to new investors by increasing the importance of profit maximization in decision making by newly private enterprises and by reducing the importance of other criteria, more difficult to foresee, that constituted real barriers to entry into the market.

He was concerned by the continuing high degree of public sector participation in the economy, Mr. Donoso considered. Many public sector enterprises were continuing to operate, and government spending had shown no tendency to diminish. He found it worrisome that the authorities felt that in order to reduce the PSBR, they might have to increase taxes. Unlike the fall in the inflation rate and the rise in competitiveness, the prospect of higher taxes contributed to uncertainty. In addition, higher taxes would further reduce net payments to labor and capital at a time when indications were emerging that there remained serious disincentives to more intensive use of existing factors of production. The overlarge share of the public sector in the U.K. economy and the apparent difficulty in reducing it served to limit future growth. The authorities still had far to go.

Sluggish investment also imposed a constraint on growth, Mr. Donoso pointed out. After all, in ranking the importance of various determinants of growth, he viewed efficiency as less important than the basic availability of factors of production. The large size of the public sector in the U.K. economy made it all the more important that the public sector should maintain its rate of savings and investment, something that was not occurring as desired. After all, the authorities had achieved their goal of reducing the PSBR at least in part through income generated by the privatization of public enterprises. The aim of privatization was to reduce the need for public expenditure, but in fact the public sector was saving and investing less than it had previously. He stressed the importance of efforts to control current public expenditure and promote public savings in order to reduce further the PSBR, facilitate private investment, and strengthen public investment directly. While private savings would take time to recover, continued recovery would depend in part on adjustments in real wages to levels consistent with higher competitiveness, as well as higher employment.

Present distortions had grown out of official efforts to control inflation, which should be maintained and even intensified, Mr. Donoso observed. He tended to agree with the authorities that, in the short run, little could be expected from exchange rate policies designed to reverse those distortions without risking unacceptable damage to stability. To minimize the effects of stabilization on the rate of capital accumulation, public sector authorities should emphasize their own efforts to save. He would consider it unfortunate if, to preserve their accomplishments, the authorities had to increase taxes or sacrifice investment; instead, they ought to contain current expenditure by the public sector.

Finally, he associated himself with other Executive Directors' comments on the rise of protectionism in the United Kingdom, Mr. Donoso said. He welcomed Mr. Wick's statement expressing the commitment of his authorities to rolling back existing restrictions. He hoped that they would be successful.

Mr. Zhang observed that 1983 had been a remarkable year for the United Kingdom in that faster growth in output had been associated with a further slowdown in inflation. Indeed, the staff had expressed the hope that the authorities had set the stage for a sustained recovery.

How much of the continued recovery in 1983 had been due to the success of the Government's medium-term policies and how much to the deviations from them that had occurred in 1982/83? Mr. Zhang asked. He could not escape the impression that the favorable consequences of the MTFS had been somewhat exaggerated. For example, overstatements were evident in the staff's discussion of productivity developments, in its assessment of recent changes in productivity and competitiveness, and in its suggestion that the decline in interest rates had been caused entirely by U.K. policies, whereas in reality the decline since 1981 had also been fostered and facilitated by developments in the United States.

The staff had pointed out in its appraisal that the recovery "no doubt drew some of its strength in 1983 from what the authorities view as temporary deviations of financial policies from their assigned paths," Mr. Zhang noted. Did the term "some strength" mean a great deal or only a little? The discussion of that question between the staff and the authorities, as summarized in Part II, Section 2b of SM/84/35, seemed not to have resolved the question of what had actually happened during 1983. In the same paper, a comparison of the actual outturns in demand and output listed in Table 2 with the forecasts made at the previous year's consultation--before the change in the financial stance had become apparent--showed that, in 1983, real domestic demand was estimated to have risen by 4 percent instead of by the 3 percent forecast; real GDP was estimated to have risen by 2.9 percent instead of the 1.5 percent forecast. The divergences had occurred because private consumption had risen more than expected, while private investment had apparently risen less than half as much as expected. The rise in private consumption by 3.7 percent, instead of the 2-3 percent forecast, had largely been due to two exceptional, one-time factors, namely, the lifting of hire-purchase restrictions and the rise in real earnings associated with the unexpectedly sharp deceleration of consumer price inflation.

By contrast, Mr. Zhang continued, private investment had risen by little more than 2 percent, compared with the forecast of over 5 percent. Apparently, even residential and commercial construction--especially sensitive to interest rates--had expanded much less rapidly than forecast, and other private investment had failed to rise from its low level of the previous year. Developments in 1983 suggested that there had been a temporary boost to real output growth, under the influence of specific measures aided by the easier financial stance, but, despite the marked rise in output, unemployment had risen from 11.7 percent to 12.5 percent. He did not consider those developments to be suggestive of a marked improvement in underlying conditions or in the climate for business activity, which was supposed to have occurred, according to the staff report. The evidence cited was far from convincing.

The deceleration of domestic inflation, as measured by the GDP deflator, had been much less marked from 1982 to 1983 than from 1981 to 1982, whereas the deceleration of retail prices had actually been somewhat greater, Mr. Zhang observed. Could the staff provide an explanation of the causes of the unexpectedly sharp decline in retail price inflation? Would he be correct in surmising that increasing import competition and external price developments had been of importance? The point had relevance to the statement on page 9 of SM/84/35 that the rapid decline in inflation had meant that the recorded rates of monetary growth had allowed ample room for recovery of output. In general, inflation had been brought down in ways that had greatly weakened the competitive position of enterprises in the exposed sector and had led to the ready availability of imports at highly competitive prices. A rapid decline in inflation attributable largely to external price effects was tending to promote a recovery of real demand, associated with heavy leakages abroad, rather than a recovery of output, investment, and employment in the exposed sector.

Had the business climate, profitability, and competitiveness improved to the point where investment and exports could take over from private and government consumption as the main sources of stimulus for 1984? Mr. Zhang inquired. In 1983, investment and exports, which together constituted more than 40 percent of GDP, had accounted for less than 20 percent of the increase in GDP. What then was the evidence for the improvement in the competitive position of U.K. business referred to on page 10 of SM/84/35? The country's share of world markets had been declining, although, allowing for exchange rate effects, relative labor unit costs had also declined slightly, while export profitability had risen. For the first time since industrialization, the United Kingdom had incurred a trade deficit on manufactured goods. As shown in Chart 2 of SM/84/35, hourly compensation in manufacturing industries had risen at the same rate as in other major industrial countries. Thus, the U.K. representatives had presented perhaps a more realistic picture than the staff when they had referred to the "still unsatisfactory profit position of enterprises" and to "competitive pressures [that] would broadly offset the effects of the recent improvement in profitability."

In 1984, domestic demand was likely to be weak, and wage increases would not accelerate; exports might increase somewhat, but unemployment appeared likely to increase as well, Mr. Zhang said. Real interest rates remained high, and their future trend was uncertain. Under present conditions, it seemed optimistic to suppose that investment in exports would replace the stimulus provided by rising private and government consumption in 1983.

Beyond the three-year horizon of the MTFS, what were the longer-term prospects for sustainable growth? Mr. Zhang asked. Were present policies sufficient to deal with the problems that the staff saw looming? The authorities should remember that structural policy measures took time to design and implement, their beneficial effects being felt only after a lag. In the meantime, unemployment seemed likely to remain substantial; unless large new investments were undertaken in high-technology "sunrise" sectors, the technical competitiveness of the economy would continue to worsen. Furthermore, the real exchange rate of sterling might decline precipitously in the late 1980s, a development that would affect the standard of living.

The staff representative from the European Department, in response to questions by Executive Directors, recalled that Mr. de Maulde had asked why the staff had not included its own forecasts of economic developments in the United Kingdom. The reason was that the staff had been in the midst of developing forecasts in connection with the World Economic Outlook exercise and had not completed them by the time the report on the United Kingdom had come out, except for the balance of payments. As the staff had refined its forecasts, they had become more and more similar to the official ones made by the U.K. authorities.

A comment had been made by Mr. Polak that a number of traditional features were missing from the staff report, the staff representative noted. The report on recent economic developments (SM/84/43) was somewhat experimental, in that the staff had attempted to keep the descriptive part brief and to focus on certain topics in the form of appendices. The staff had not managed to achieve its initial goal of keeping the paper short, but the goal did explain why a number of topics had been crowded out. For instance, a discussion of the energy sector had been practically omitted on the present occasion but would be thoroughly covered at the time of the next consultation.

A number of questions on financial policies had been raised by Mr. Finaish, Mr. Tvedt, and Mr. de Groote, who had all suggested that there might be some advantages in a more expansionary fiscal policy, the staff representative went on. Those Directors had pointed to events in 1983, when the slippage in fiscal policy had appeared to have had no unfavorable effects on inflation, although it had buoyed the recovery. Either of two outcomes was possible. If the authorities loosened monetary policy and fiscal policy together, after a lag the relaxation of monetary policy was bound to be reflected in a higher rate of inflation, and the U.K. authorities seemed determined to stick to a strict monetary policy over the medium term. Thus, he would answer Mr. Arias's question about monetary policy in the next few years by noting that the policy was one of steady deceleration of monetary growth, in line with an implicit target for nominal GDP; the rate of expansion should fall progressively, leaving more room for increases in real output and less room for increases in prices. If, on the other hand, the authorities loosened only fiscal policy, the danger was that the resulting rise in the PSBR would push up interest rates to levels that would themselves provide a further impetus to an appreciation of the exchange rate for sterling, which the United Kingdom could not afford. As several Directors had expressed worries about the country's competitiveness, any policy mix triggering a rise in both the exchange rate and interest rates seemed clearly undesirable. Higher interest rates might also tend to discourage investment; over time, a slackening of investment would make the present recovery unsustainable.

A question had also been posed by Mr. Finaish about the U.K. authorities' plans for capital expenditure over the next three years, within a total of unchanged public spending in real terms, the staff representative noted. The way in which statistics were presented had somewhat magnified the decline in real capital spending that had taken place in recent years. For one thing, the figures included sales of assets that counted as deductions from capital expenditures. Thus, recorded capital expenditures turned out to be lower than they would otherwise have appeared. The most recent figures received by the staff suggested that there had actually been a slight increase in capital spending in real terms from 1978/79 to 1983/84. Projections for 1984/85 showed a slight decline of 2.7 percent relative to 1983/84 in real terms.

Several questions had been asked about competitiveness and the exchange rate, the staff representative went on. In particular, Mr. de Groote had wondered whether the authorities had acted to resist a decline in the nominal exchange rate, in view of the increase in official reserves. It should be noted that a decrease in official reserves did not necessarily reflect intervention to support the current exchange rate. There was no evidence, except for smoothing operations, to indicate that the authorities were attempting to influence the rate in one direction or the other. At present, it was difficult to find fault with the exchange rate policy being followed: the policy mix was not one that supported the exchange rate at an artificially high level.

A number of Directors had wondered whether the exchange rate would prove sustainable over time, the staff representative remarked. On that point, the U.K. authorities had adopted a wait-and-see attitude. They would prefer the necessary adjustments in the real exchange rate to take place in the form of lower costs, particularly lower labor costs, which would also have the beneficial effect of stimulating employment.

Another question on the exchange rate, posed by Mr. Angeloni, related to the decline in petroleum output expected in the years to come, the staff representative noted. The U.K. authorities agreed that a decline in exports of petroleum would normally lead to a depreciation in the real exchange rate, but both the size and the timing of such a depreciation were quite unpredictable. As for the timing, there had recently been a sharp increase in exploration for oil, in part owing to fiscal incentives given to oil companies to pursue such exploration. Moreover, market participants might not wait until the effects of the decline in oil production had been transmitted to the current account; they might push the exchange rate down in anticipation of a worsening in the country's current account position. The size of any drop in the exchange rate for sterling was also unpredictable. Mr. Wicks had made the important point that, even if the benefits of oil did turn out to be temporary, the coming on stream of North Sea oil would still justify an appreciation in the exchange rate over time, because the authorities had invested their current account surpluses in foreign assets that would for a long time provide a flow of interest and dividends into the country.

Turning to the labor market, the staff representative recalled that both Mr. de Maulde and Mr. Angeloni had asked about the prospects for an incomes policy. Experience with such a policy in the United Kingdom since World War II had not been favorable, and the authorities at present were not prepared to move in that direction. They had however found it useful to fix strict guidelines for wage settlements in the public sector; for 1984/85, there was a 3 percent cash limit on increases in the wage bill for public employees. The authorities hoped that the strict guidelines would set a pattern for the private sector.

Causes of productivity increases in recent years had been the subject of a question raised by Mr. Finaish, who had wondered whether the increases might have been attributable to the disappearance of low-productivity firms, the staff representative stated. During the consultation discussions, the U.K. representatives had responded to a similar question by saying that there was no evidence indicating that, during the recession, it had been predominantly the low-productivity firms that had disappeared. There was a difference between low productivity and inefficiency or lack of competitiveness. For instance, a steel firm normally operated as a high-productivity firm in terms of value added per worker, but it could be inefficient and uncompetitive. By contrast, a textile or service firm could show low productivity in the sense that it employed a great deal of labor, but it could also be extremely efficient. Available evidence indicated that, during the recession, the proportion of high-productivity firms and low-productivity ones having gone out of business had been about the same: inefficient firms had disappeared, whether high-productivity or low-productivity. What he found worrisome in the United Kingdom, as in Belgium, was that recent gains in productivity had occurred on an industrial base that was becoming steadily smaller.

In response to Mr. Senior's question about the reasons for continued high unemployment at a time of recovery, the staff representative from the European Department explained that firms might be waiting to hire new labor until they were more certain about the prospects for the economy. As in a number of other countries, there were also a number of obstacles to layoffs that might discourage firms from hiring new workers. Moreover, if a firm did not find it profitable to produce at a given level of wages, it was not going to produce more even if there turned out to be increased demand for its product, because it would be unable to meet the competition from foreign producers or even from other domestic producers. Thus, high real wages in the United Kingdom continued to cloud the prospects for higher employment. As to Mr. Finaish's question whether it was possible to determine how much of the unemployment was demand related and how much was structural, he would have to say that there was probably some of each, although structural unemployment seemed to predominate.

The Executive Directors agreed to continue their discussion in the afternoon.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/84/29 (2/24/84) and EBM/84/30 (2/27/84).

2. PAKISTAN - TECHNICAL ASSISTANCE

In response to a request by Pakistan for technical assistance, the Executive Board approves the proposal set forth in EBD/84/52 (2/17/84).

Adopted February 24, 1984

3. RELATIONS WITH GATT - CONSULTATIONS WITH CONTRACTING PARTIES - FUND REPRESENTATION

The Executive Board approves Fund representation at the next round of GATT consultations to be held in Geneva, as set forth in EBD/84/53 (2/17/84).

Adopted February 24, 1984

APPROVED: August 13, 1984

LEO VAN HOUTVEN
Secretary