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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 84/31

3:00 p.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	
	X. Blandin
A. Donoso	
R. D. Erb	
M. Finaish	
T. Hirao	T. Yamashita
J. E. Ismael	
R. K. Joyce	
	J. R. N. Almeida, Temporary
G. Laske	
	I. Angeloni, Temporary
	C. J. Batliwalla, Temporary
	S. El-Khouri, Temporary
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: I. Otani. European Department: P. B. de Fontenay, O. J. Evans, P. Gotur, M. T. Hadjimichael, S. Mitra, S. M. Thakur. Exchange and Trade Relations Department: C. D. Finch, Director; G. G. Johnson. Legal Department: S. A. Silard. Secretary's Department: J. C. Corr. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: K. A. Hansen, Y. Okubo, I. R. Panday, M. Z. M. Qureshi, D. C. Templeman. Assistants to Executive Directors: L. E. J. M. Coene, M. Eran, V. Govindarajan, H. Kobayashi, M. J. Kooymans, G. W. K. Pickering, M. Rasyid, J. Reddy, D. Robinson, Wang C. Y.

1. UNITED KINGDOM - 1983 ARTICLE IV CONSULTATION

The Executive Directors resumed from the previous meeting (EBM/84/30, 2/27/84) their consideration of 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).

The staff representative from the European Department, continuing his reply to Mr. de Groote, observed that since 1981 the official reserves of the United Kingdom had decreased by about £4 billion. The decrease was however not inconsistent with smoothing operations undertaken during a period in which the exchange rate of sterling had also been moving down.

The first question asked by Mr. Zhang had been on the role of the Government's medium-term policies in the recovery, particularly in 1983, the staff representative recalled. In 1981, at the bottom of the recession, the authorities had introduced a tough, restrictive budget with the intention of bringing down inflation and interest rates. At that time, the Prime Minister had come under strong pressure to shift policy in a more expansionary direction; she had not turned around, but the economy had. The fall in inflation and interest rates had certainly contributed to the recovery. In 1983, as noted by Mr. Zhang, a temporary deviation of fiscal and monetary policies from the medium-term target had contributed to the strength of the recovery, although how much was difficult to say. One figure cited by the staff was that the budget had provided a fiscal stimulus equal to about 0.4 percent of GDP, compared with the rate of growth in the United Kingdom in 1983 of 2.5 percent. Therefore, the staff would conclude that the contribution made by the temporary deviation had been noticeable, but not large. Other factors had contributed to the recovery, particularly the removal of credit on hire purchase, which had led to a boom in private consumption that had, however, been accommodated within the monetary targets. Had that boom not taken place, some other form of credit would normally have expanded, or interest rates would have declined, so that the exchange rate for sterling would have been different.

As Mr. Zhang had observed, the staff representative went on, private investment had been fairly weak during 1983, a development not inconsistent with previous recoveries. Typically, consumption and stockbuilding provided the initial stimulus, and only at a later stage did investment begin to pick up.

The second question asked by Mr. Zhang had been on prices, the staff representative noted. Mr. Zhang had pointed out that the deceleration in retail price inflation had been more marked than that of the GDP deflator from 1982 to 1983 compared with 1981 to 1982. Those developments were somewhat puzzling, because in 1983 the exchange rate had been depreciating slightly; if only for that reason, he would have expected retail prices to increase faster than the GDP deflator. There might well have been other temporary influences on retail prices, such as mortgage interest rates.

What effect the improvement in business profitability could be expected to have on a recovery of investment and exports had been the subject of Mr. Zhang's third question, the staff representative said. Between the third quarter of 1982 and the third quarter of 1983, company profits had risen by more than 30 percent, although admittedly from a fairly low base. Still, the change was linked to the behavior of prices on the stock exchange, greater optimism in enterprises, and some upward revisions in their plans for investment, as reflected in business surveys.

It had been noted by Mr. Zhang that the prospects for investment should be seen in the light of fairly weak domestic demand, the staff representative continued. Domestic demand was not actually so weak: in 1983/84 it had expanded by about 3.5 percent, a respectable rate. The problem was that some of that demand had leaked abroad, something that again brought up the question of the United Kingdom's competitiveness. In view of the close relationship between profitability and competitiveness, further improvements in business profits and in investment would depend on whether enterprises could achieve further gains in the overall competitiveness.

The question raised by Mr. Zhang about the prospects for the United Kingdom beyond the three-year horizon of the Medium-Term Financial Strategy (MTFS) had been addressed in the staff appraisal, the staff representative pointed out. The staff had indicated that the authorities should shift resources to exports and investment. With oil production likely to peak soon, the balance of payments would require greater support from non-oil exports; more investment was needed in order to improve the productivity of the U.K. economy, which was still some 25-30 percent lower than in France or in Germany. In the staff's view, the best way to achieve a larger volume of exports and investment would be to reduce government spending and allow a fall in interest rates, which would both give an incentive to investment and diminish upward pressures on the exchange rate, thus restoring some of the lost competitiveness.

Finally, the staff representative from the European Department noted, the slippages in 1983 had reflected the success of the authorities' policies in the sense that inflation had fallen far enough and competitiveness had risen far enough so that they could afford temporary deviations in the MTFS. They had been unable to allow such deviations when inflation had been running at double-digit rates, as it had been doing until 1982.

Mr. Wicks commented that the message given by Executive Directors had been that the policies of the U.K. authorities were generally on the right track but that a great deal remained to be done. As Directors had expressed concern at the future competitive position of the U.K. economy, his authorities would agree that there had to be an improvement in the medium term for the country to have a solid external position, sustainable domestic growth, and, above all, a lower rate of unemployment. One of the central concerns of the authorities was how to improve competitiveness.

Some Executive Directors had suggested that an incomes policy or direct action on costs might be suitable, Mr. Wicks remarked. As the staff representative from the European Department had pointed out, the authorities' long experience with implementing various incomes policies had been disappointing. While there might have been a case for an incomes policy immediately after the Government had assumed office in 1979, with the intention of breaking inflationary expectations, there was no place for one at present; the Government was unlikely even to contemplate such a policy.

Other Executive Directors had mentioned possible direct action to lower the exchange rate and improve competitiveness, Mr. Wicks noted. Those who had followed what the authorities had attempted to accomplish during the past 25 years by successive devaluations of sterling--some formal, some informal--would observe that their success had not been great. He was left with the conclusion that the way to improve the competitiveness of the U.K. economy was to follow the difficult path of trying to restrain domestic costs in order to improve efficiency and to stimulate better design and better terms in order to make U.K. goods more competitive. Indeed, they had had some success in that endeavor during the past few years.

His authorities agreed with the Executive Directors who had said that labor costs had been rising too rapidly, Mr. Wicks went on. The authorities had in fact set tight guidelines for wage increases in the public sector, which had largely been adhered to. They would however maintain vigilance over public sector wage claims.

Some stress had been placed on the relative decline of manufacturing in the United Kingdom, Mr. Wicks recalled. Certainly the authorities wished to encourage a thriving and prosperous manufacturing sector, and there were signs that the corner had been turned. Nonetheless, the importance of manufacturing in the U.K. economy should not be exaggerated. For example, one third of the country's gross current account credits at present derived from invisibles, which were equivalent to 75 percent of total receipts from manufacturing. Just as the structure of the domestic economy was changing, so was the balance of payments. While on the subject, he wished to point out that the figures given in Table 5 of SM/84/43 seemed to suggest that investment in plant and machinery was continuing to fall. In fact, anyone who read figures on investment in the United Kingdom should bear in mind that, for tax reasons, a bank often bought manufacturing equipment and leased it to a manufacturing company. Often, the purchase of such an asset was logged under the services or financial sectors when, in fact, the asset was going to be used in manufacturing. Thus, the declining trend in gross fixed investment by manufacturing had not been as severe as it looked.

Some Executive Directors had tactfully noted that there had occurred a slight deviation in monetary policy in 1983, Mr. Wicks went on. Monetary policy was now back on track: the aggregates were growing within the target ranges, and public expenditure remained firmly under control.

While the staff appeared to regard the projected figures for the next three years as ambitious, the authorities regarded them as realistic. Within the totals of public spending that had been published, the authorities had recently allowed for a much larger contingency reserve for unexpected expenditure. For 1984, the reserve was £3 billion, a substantial amount providing added assurance that the authorities would keep to the projected totals for public spending.

The aging of the population, expanding health technology, and assumptions of an ever-rising standard of medical care were putting tremendous pressure on public expenditure, Mr. Wicks acknowledged. The problem spanned many European countries as well as the United States. Perhaps the Fiscal Affairs Department of the Fund could undertake a study setting forth international comparisons of such costs: important political choices would have to be made soon, and national authorities could make those choices only if their electorates were informed of the various options. In a nonpolitical way, the Fund could perform a useful service by assembling such information in an international perspective.

Some interesting comments had been made by Directors on protectionism in the United Kingdom, Mr. Wicks recalled. Mr. Joyce had put it well by noting that, as a major trading nation, the United Kingdom had a vital interest, perhaps greater than that of most countries, in maintaining open markets. On another point, his authorities would accept a great deal of what Mr. Morrell had said about the impact on the U.K. budget of the Common Agricultural Policy of the European Communities.

Official development assistance provided by the United Kingdom was expected to rise by 6 percent from 1983/84 to 1984/85, Mr. Wicks observed. As the increase was going to be well in excess of the expected inflation rate, there should be a modest rise in real terms. Under the heading of ODA, the staff paper had mentioned that the combined total of official and private capital flows from the United Kingdom to developing countries came to 1.3 percent of GDP, quite a sizable figure. Indeed, he suspected that private industry in the United Kingdom would be ready to send more money to the developing countries were the way open in some countries to do so.

The Chairman commented that Mr. Wicks had made a useful suggestion about the possibility of a study by the Fiscal Affairs Department on international comparisons of some long-term public expenditures, especially transfer payments and health care.

The Chairman then made the following summing up:

> Executive Directors warmly commended the U.K. authorities for the role that their policies had played in the improved performance of the economy. They noted, in particular, that the recovery in activity since mid-1981 had not prevented further progress in reducing inflation to the lowest rate in 16 years. Prospects seemed favorable for a continuation of the recovery in

1984 without a reacceleration of inflation, but Directors noted that so far the recovery was largely based on consumer demand fueled by a sharp reduction in the savings ratio and on stock-building, while productive investment remained weak. Directors found it encouraging that employment had started to increase, and that unemployment seemed to have leveled off, though they noted with regret that there was little prospect of a sizable reduction in the number of unemployed in the immediate future. Directors remained concerned by the continued real wage increases despite the high level of unemployment, as they retarded the pricing of labor back into jobs. The gains in labor productivity recorded in recent years had, however, mitigated the effect of the relatively large increases in wages on inflation and competitiveness.

Noting that the improvement in profitability and competitiveness since 1981 was narrowly based, in view of the shrinking of the manufacturing sector, and that the deterioration in the non-oil trade balance was not fully explained by cyclical developments, Directors generally agreed that the present level of the real exchange rate did not appear consistent with current account equilibrium over the medium term, especially if account were taken of the approaching decline in oil production. Accordingly, they regarded slower gains in wages as essential to an improvement in competitiveness. In this context, a few Directors believed that an incomes policy could be helpful to achieve that objective. The importance of strong restraint on public sector salaries was also stressed by a number of Directors. Directors considered that a reduction of costs was the best course of action toward restoring competitiveness, although exchange rate flexibility should be carefully maintained. In this regard, Directors commended the authorities for not resisting a depreciation of the nominal effective exchange rate, noting that the depreciation recorded since 1981 had bolstered competitiveness without reigniting inflation.

Directors praised the contribution of financial policies to the reduction of inflation and commented that the policy mix in recent years had been generally successful in avoiding upward pressures on interest rates and on the exchange rate. However, they also noted the slippage from both fiscal and monetary targets that had occurred in the course of 1983. Most Directors welcomed the authorities' determination to return to the targets of the Medium-Term Financial Strategy (MTFS) in 1984/85 and to keep public spending unchanged in real terms. They supported the Government's objective of achieving a reduction in the size of the public sector relative to GDP, which would allow for both tax cuts and a further reduction in the public sector borrowing requirement, and thereby improve private investment opportunities and the performance of the economy. A few Directors, in contrast, wondered whether--in view of the unemployment situation, of the uncertain outlook for aggregate demand, and of the favorable results on the inflation front--some flexibility in the conduct of fiscal policy might not be desirable at this point.

On monetary policy, Directors noted that 1983 had seen an interruption of the continuing monetary deceleration that had been the hallmark of the MTFS, but they welcomed the progress that had been made recently in bringing the rate of growth of monetary aggregates closer to the targeted range. Directors stressed that continued monetary restraint was necessary to avoid the risk of a resurgence of inflation.

With regard to the medium term, a number of Directors expressed preoccupation about the prospects for sustainable growth. Particular concern was expressed with regard to the reduction in the size of the manufacturing sector, the continued weakness of investment in that sector, and the deterioration in the non-oil trade balance. Several Directors believed that, in spite of considerable progress in deregulation, structural change in the U.K. economy in recent years had been insufficient. Directors stressed that appropriate and consistent financial policies, though necessary conditions, were not by themselves sufficient to generate better economic performance, and concurred that additional structural actions to enhance the efficiency and flexibility of the economy were essential. Directors referred in particular to the areas of labor market reform and tax and trade policies. They advocated further measures to foster labor mobility and real wage flexibility, as well as changes in the tax system that would reduce disincentives for some employees to work and for employers to hire new labor.

Many Directors, mindful of the strengthening of protectionist pressures in the United Kingdom, emphasized the importance of trade policy liberalization in industrial countries as a requirement for worldwide recovery, and hoped that the United Kingdom would play a leadership role in rolling back protectionist measures and in promoting trade liberalization. Directors noted the sizable private financial flows to developing countries and urged the authorities not to scale down official development assistance; the recent reduction in multilateral aid flows was viewed with concern by some Directors.

It is expected that the next Article IV consultation with the United Kingdom will be held on the standard 12-month cycle.

The Executive Directors concluded the 1983 Article IV consultation with the United Kingdom.

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/84/30 (2/27/84) and EBM/84/31 (2/27/84).

2. AFRICAN CENTRE FOR MONETARY STUDIES (ACMS) - SEMINAR - FUND PARTICIPATION

In response to a request from the African Centre for Monetary Studies, the Executive Board approves the proposal set forth in EBD/84/55 (2/22/84).

Adopted February 27, 1984

APPROVED: August 13, 1984

LEO VAN HOUTVEN
Secretary