**FOR AGENDA**

SM/83/18

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January 24, 1983

To: Members of the Executive Board

From: The Secretary

Subject: United Kingdom - Staff Report for the 1982 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1982 Article IV consultation with the United Kingdom.

*This subject has been tentatively scheduled for discussion on* Wednesday, February 23, 1983.

Att: (1)

Other Distribution:
Department Heads

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INTERNATIONAL MONETARY FUND

UNITED KINGDOM

# Staff Report for the 1982 Article IV Consultation

Prepared by the Staff Representatives for the 1982 Consultation with the United Kingdom

Approved by L. A. Whittome and Subimal Mookerjee

January 20, 1983

## I. Introduction

A staff team, consisting of Messrs. Schmitt, Vittas, Lipschitz (all EUR), Mr. Boughton (RES), Mr. van den Boogaerde (EP, EUR), and Ms. Walters (EUR) as secretary, held Article IV consultation discussions in London from December 3 to 13, 1982. The U.K. representatives included officials of the Treasury, the Central Statistical Office, the Department of Energy, the Department of Employment, and the Bank of England. Messrs. Schmitt and Vittas also met the Chancellor of the Exchequer, Sir Geoffrey Howe, and the Governor of the Bank of England, the Rt. Hon. Gordon Richardson. Mr. John Anson, Executive Director for the United Kingdom, attended the meetings as an observer. The United Kingdom formally accepted the obligations of Article VIII, Sections 2, 3, and 4, as of February 15, 1961.

## II. The Economic Background

After 18 months of declining domestic demand, there was a turnaround in the second half of 1981 that has been sustained through 1982. The growth of demand has not elicited a commensurate domestic supply response, but instead has contributed chiefly to a weakening of the foreign balance. Thus, while total domestic demand has increased at an annual rate of 2 1/2 per cent in the last 18 months, real GDP has risen by less than 1/2 per cent. Consequently, the unemployment rate has risen to 13 per cent. Over the same period, retail price inflation has been almost halved. There has been some depreciation of the real exchange rate--that is, relative unit labor costs adjusted for exchange rate changes--and some improvement in profit margins of industry. However, rates of return on capital in non-oil industries are still very low by historical standards, and industry in the United Kingdom has continued to lose market shares both at home and abroad. The current account surplus has fallen from 2 1/2 per cent of GDP in 1981 to about 1 1/3 per cent in 1982.

## 1. Oil shocks and the financial strategy

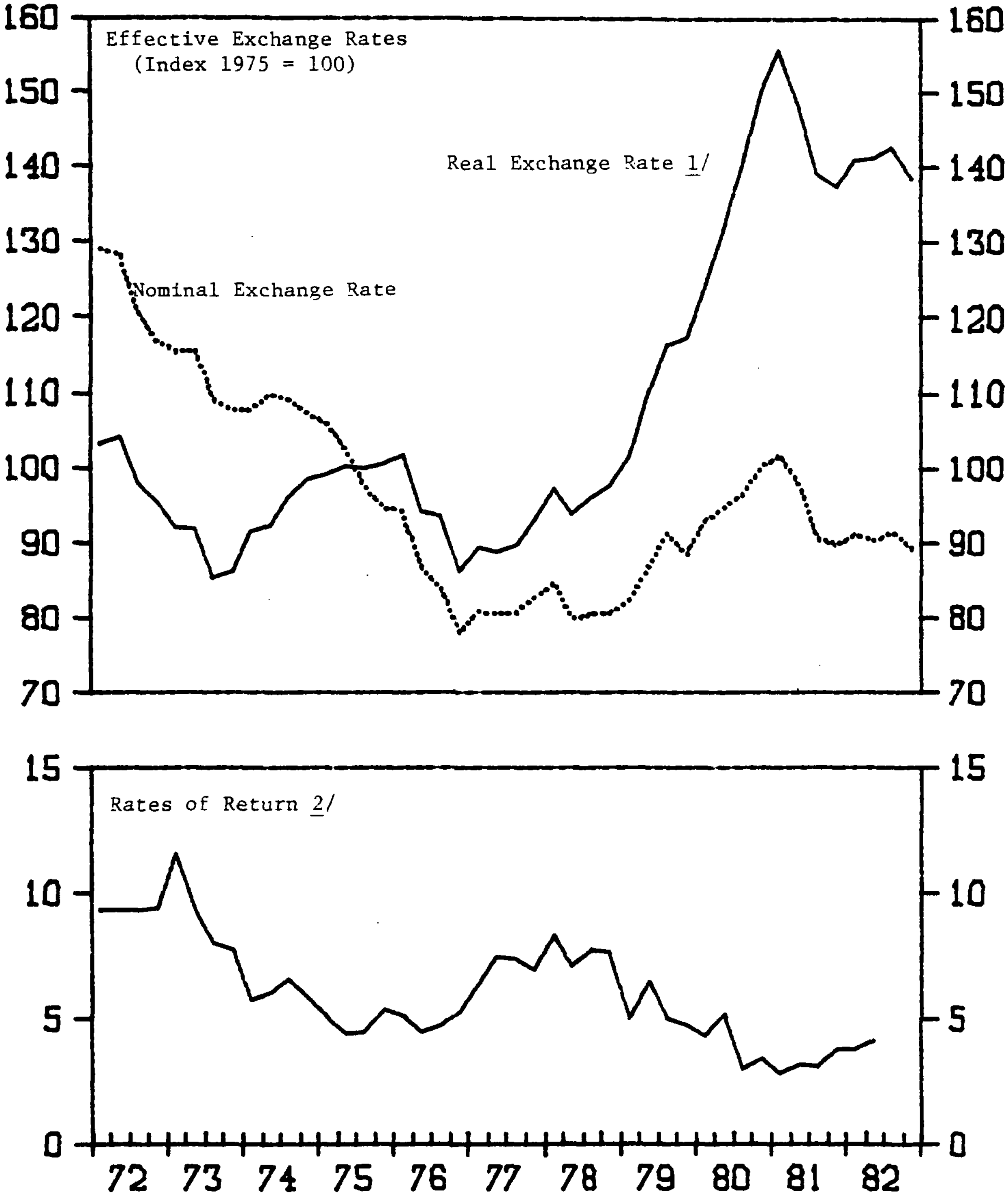
In the United Kingdom, as in other industrial countries, the oil shocks of the 1970s imposed a new constraint on production in industry in general and manufacturing in particular. This energy constraint reduced the productivity of labor and capital, resulting in a fall in the real rate of return on capital in the nonenergy sectors and leading, in the absence of real wage adjustments, to an increase in the underlying unemployment rate. Additional financial stimulus does not by itself counter this kind of unemployment; instead, reasonable rates of return in industry need to be restored.

While these developments have been true of non-oil industry in most industrial countries, at the end of the decade and in the subsequent two years, two special factors also affected economic trends in the United Kingdom. First, the emergence of the United Kingdom as a major oil producer strengthened the external payments position and the rate of exchange of sterling. Second, the announcement and implementation of the strongly anti-inflationary Medium-Term Financial Strategy (MTFS) in 1979-80 affected markets differently. The strategy was immediately credible in financial markets; sterling appreciated sharply in the exchange markets, and long-term interest rates fell below short-term rates for the first time in the decade. In the labor market, however, the response was slow and credibility was undermined by the substantial increase in public sector pay in 1979/80 as well as by higher oil prices and the price effects of the near doubling of the value-added tax (VAT) at about the same time. Strong wage push pressures, together with the appreciation of sterling, contributed significantly to the worsening of the external competitiveness of British non-oil industries and to the deterioration in real rates of return on capital in these industries. Between 1978 and the peak in the first half of 1981, sterling appreciated in real terms by some 60 per cent, while the pretax real rate of return on non-oil industrial capital fell from over 7 per cent to around 2 per cent (Chart 1).

The MTFS has been very methodical in its approach to financial policy. Nominal monetary and fiscal targets were established with a view to exerting persistent downward pressure on the rate of growth of total expenditure in nominal terms (Table 1). The division between real growth and inflation within the nominal demand projections was left to be determined largely by market forces and, in particular, pay and productivity developments in the labor market. Formal incomes policy was shunned as the Government believed that it had achieved very little success historically in the United Kingdom. Indeed, incomes policy was seen as having distorted relative wage rates across industries by not allowing differential adjustments to different patterns of demand and productivity, and as having had, at best, only a very short-term effect on wage inflation. Even though the Government was not able to adhere strictly to its nominal monetary and fiscal targets in the first years of the MTFS, financial policies were very tight, and narrow money balances declined in real terms.

CHART 1

EFFECTIVE EXCHANGE RATES OF STERLING AND
RATES ON RETURN ON CAPITAL




Sources: IMF, International Financial Statistics: and information provided by the Bank of England.

1/ Relative unit labor costs in manufacturing adjusted for exchange rate changes.

2/ Ratio of earnings (gross trading profits--excluding North Sea sector--plus rent received less depreciation and profits due to stock appreciation) to the average capital stock in the period. Capital stock and allowances for capital consumption are valued at current replacement cost.

In these circumstances, it was difficult for companies to accommodate wage cost pressures, and employment consequently fell precipitously. Inflation was much higher and real growth much lower than had been expected.

Over the last two years the credibility of the Government's stringent financial stance has become generally established. In 1981/82 (fiscal years begin on April 1) the Public Sector Borrowing Requirement (PSBR) amounted to only about 3 1/2 per cent of GDP, well below the budgeted 4 1/4 per cent of GDP. In the current year the PSBR again appears to be below budget despite recent actions to reduce the tax burden on industry and employment. Although difficulties in abiding by the target range for money growth persisted through 1981/82, a variety of supplementary indicators--such as interest rates and the exchange rate--suggest that monetary policy was reasonably stringent. After the target range was raised and its coverage broadened, all of the target aggregates have thus far remained within the range for the current year.

The processes initiated in the first years of the MTFS have worked their way slowly through the economy. By now, the costs of implementing a program of financial restraint in the face of slow-reacting labor markets are widely appreciated, and some of the benefits of having remained resolute are starting to come through. Wage and price inflation have been reduced substantially, and nominal interest rates have fallen sharply. Growth, employment, and the competitiveness of British industry at home and abroad have remained the most disappointing areas of economic performance.

## 2. The domestic economy

The early period of the MTFS saw an acceleration of wage-led price inflation and a profit squeeze unprecedented in recent times. Average earnings rose by 21 per cent in 1980, while labor productivity in manufacturing fell by 1 1/2 per cent; thus, unit labor costs rose by more than 22 per cent. Fuel and raw material costs increased by 20 per cent for manufacturing industry. Output prices, which rose by only about 16 per cent, were constrained by tight financial conditions and weak demand in the domestic market coupled with a worsening competitive position abroad. Profit margins therefore were reduced and, with demand faltering and capacity utilization falling, rates of return on capital fell even more sharply. The profit squeeze was evident in all non-oil industries, but the manufacturing sector, which is particularly exposed to foreign competition, was most seriously affected. These relative price developments accelerated the tendency for the share of manufacturing industry to decline in the economy as a whole, hastened structural adjustment, and exacerbated frictional unemployment.

Continuing tight financial conditions forced companies to adjust quickly to higher labor costs and weaker demand by a substantial laying off of workers and running down of inventories. The reduction of stocks alone would have led to a fall in real GDP of about 3 1/2 per cent in

1980. However, as some other components of demand continued to grow, GDP fell by only about 2 per cent. The rapid laying off of workers meant that productivity held up relatively well in the initial downturn, and this prepared the groundwork for the subsequent improvement in productivity.

Since the middle of 1980, some indications of improving cost and price conditions have begun to emerge (Chart 2). The nominal effective exchange rate depreciated by 16 per cent from its peak in the first quarter of 1981 to its level in December 1982. Between the last quarter of 1980 and the third quarter of 1982, unit labor costs in manufacturing rose at an annual rate of less than 4 per cent, owing both to wage restraint and to an increase in productivity of almost 7 per cent at an annual rate. The competitiveness of the United Kingdom correspondingly improved. The real exchange rate depreciated by almost 9 per cent between the first quarter of 1981 and the third quarter of 1982. Profit margins widened and the pretax real rate of return on capital in non-oil industry picked up from a historic low point of slightly over 2 per cent to around 4 per cent in mid-1982. Nominal interest rates also fell sharply; banks' base rates, having peaked at 17 per cent in the first half of 1980, fell from 15 per cent at the end of 1981 to 10 per cent at the end of 1982. Despite the depreciation of sterling, and owing in part to extremely low international commodity prices, the rate of retail price inflation, which had peaked at over 21 per cent in the first half of 1980, fell from 12 per cent at the end of 1981 to 6 1/2 per cent in the fourth quarter of 1982.

These favorable financial developments have begun to have an effect on the real economy, too. Real GDP, which fell by more than 2 per cent in 1981, is estimated to have increased by 1/2 per cent in 1982, owing in large part to a much slower running down of inventories (Table 2). Fixed investment in 1982 has been more buoyant than generally expected, but the proportion of plant and machinery in the total has tended to fall. The real rate of return on non-oil capital is still well below the 7 per cent achieved in 1978 and the rates of 10 per cent or better that obtained through most of the 1960s. Industry in the United Kingdom is continuing to lose market shares at home and abroad. Although the demand for manufactures in the domestic economy changed very little from 1977 through the first half of 1982, import volumes rose by 40 per cent, while manufacturing output in the United Kingdom fell by 14 per cent. Over the same period, the volume of world trade in manufactures rose by about 18 per cent, while U.K. exports of manufactures were unchanged.

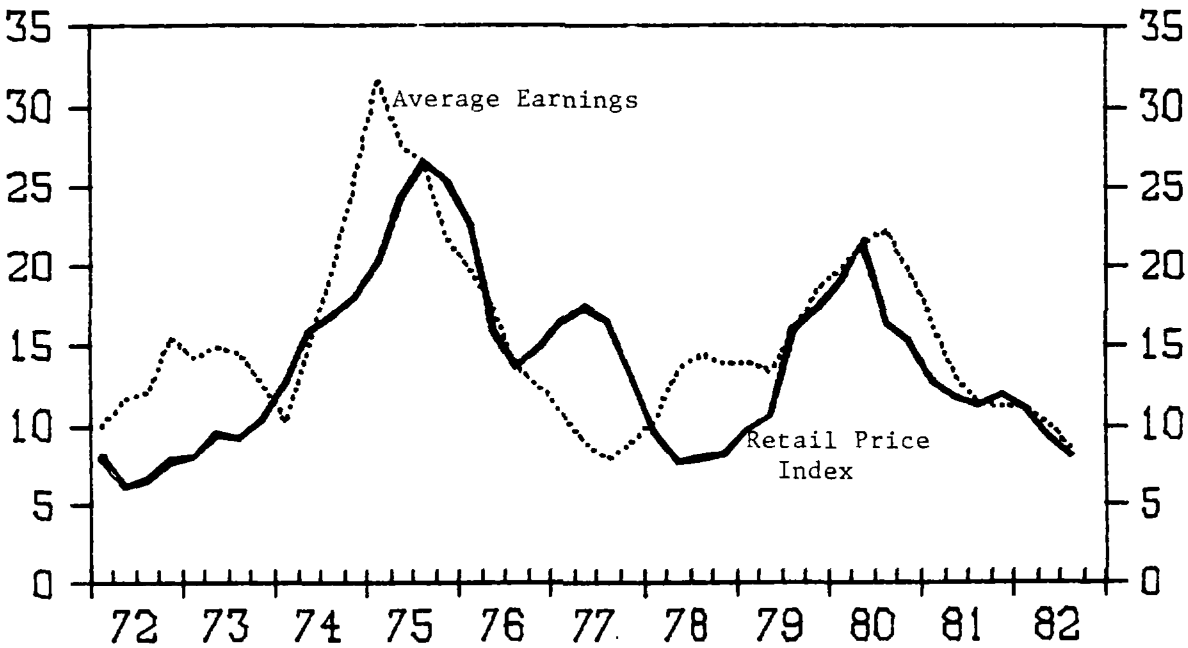
The labor market also remains extremely weak (Chart 3). The adult unemployment rate rose from 11 1/2 per cent to about 13 per cent during 1982. To the extent that productivity has improved--and this has been necessary both in order to improve competitiveness and to allow some non-inflationary increase in earnings and demand--the growth of output has had less of an impact on employment. Competitiveness will have to continue to improve if greater domestic demand is to result in an acceleration of output growth. Insofar as the current rate of productivity growth continues, even the most sanguine projections would not envisage a reduction in unemployment in the immediate future.

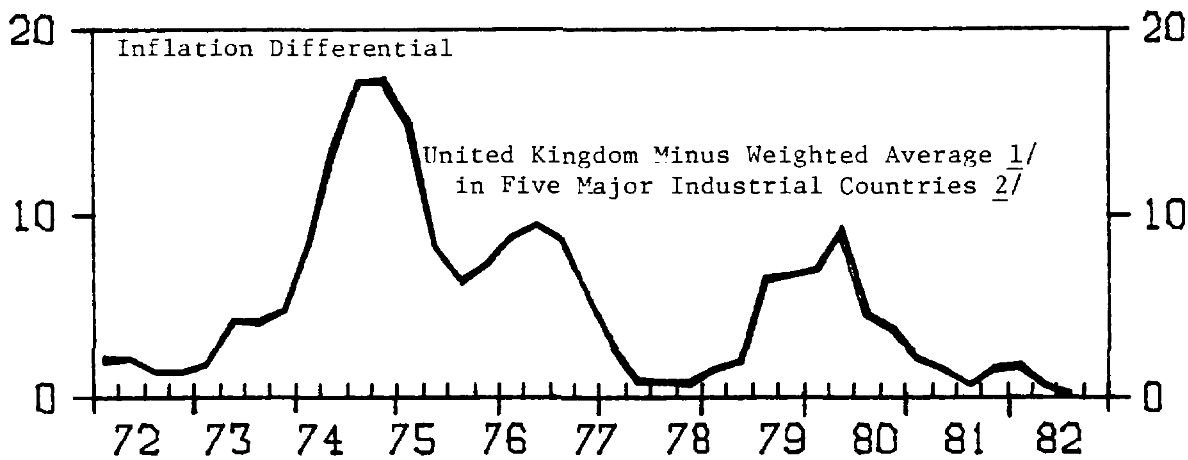
CHART 2

UNITED KINGDOM

WAGE AND PRICE DEVELOPMENTS

(YEAR-ON-YEAR RATE OF CHANGE, IN PER CENT)




Sources: IMF, International Financial Statistics: and Central Statistical Office, Economic Trends.

1/ Weighted in accordance with 1975 shares in U.K. exports.

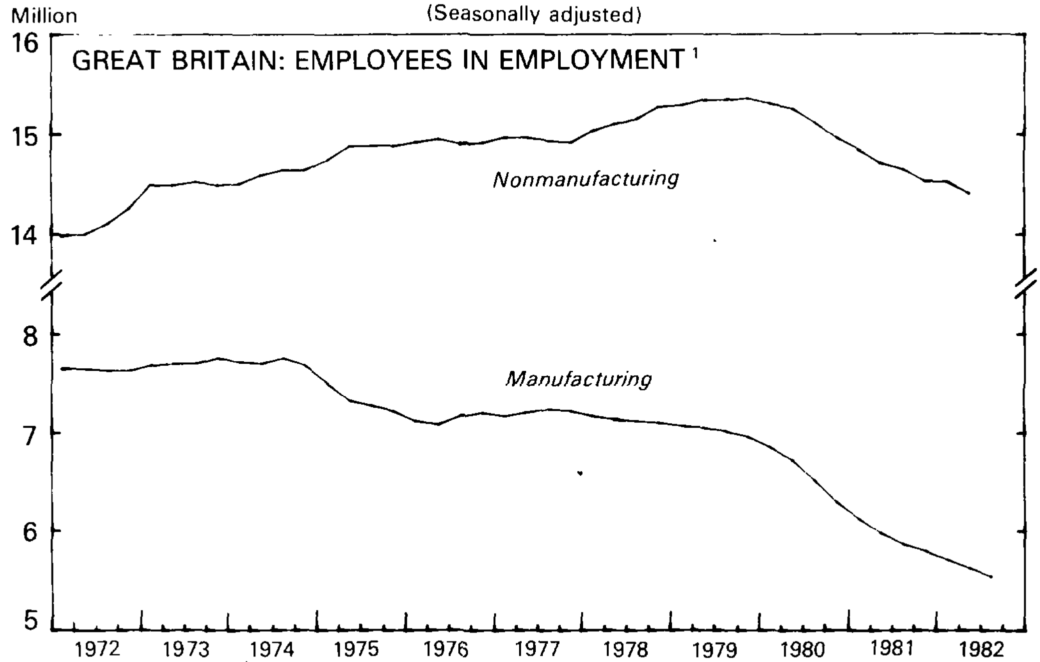
2/ France, Germany, Italy, Japan, and the United States.

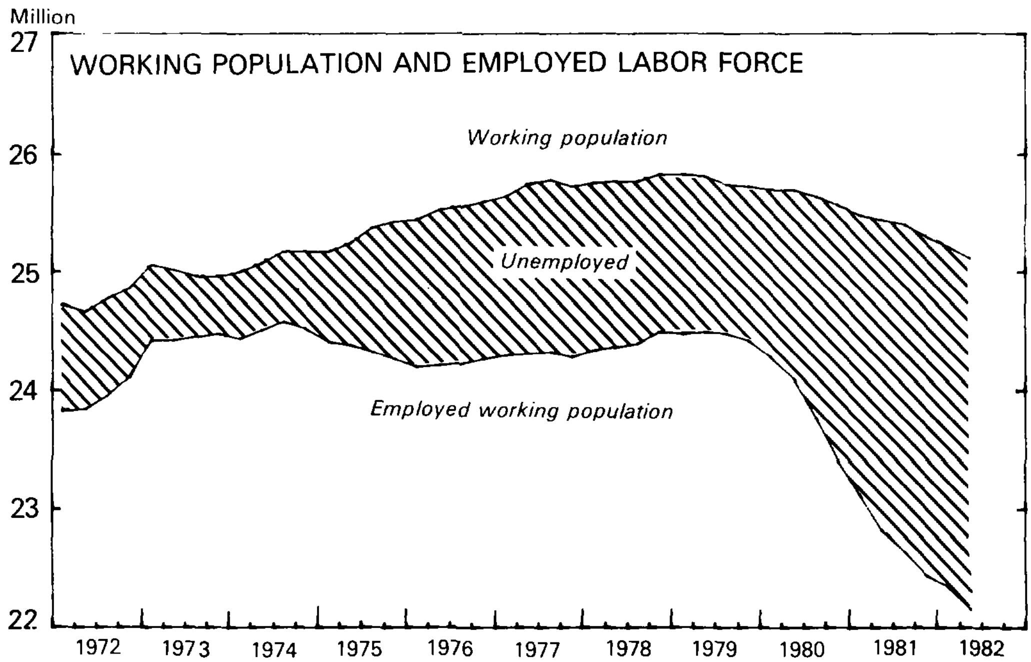
CHART 3

UNITED KINGDOM

# EMPLOYMENT, 1972-82

(Seasonally adjusted)




Source: U.K. Department of Employment: *Employment Gazette*.

[1]Equal to the employed work population, minus HM Forces and self-employed persons.

3. The balance of payments

Trade in oil and petroleum products moved into surplus in 1980. In the subsequent two years, the surplus on oil trade widened, while a deficit appeared on non-oil trade. Oil exports exceeded imports by £3 billion in 1981 and by £2.8 billion in the first three quarters of 1982. In the latter period, the volume of oil exports rose by 5 per cent, while that of oil imports fell by 4 per cent.

With respect to non-oil exports, the United Kingdom has continued to lose market shares. In 1981 non-oil export volume fell by about 3 per cent, while market growth--that is, the weighted average of partner countries' non-oil imports--rose by 2 1/2 per cent. In 1982 non-oil export volume is estimated to have fallen slightly despite market growth of between 1/2 and 1 per cent. Although this export performance is worrisome, losses in market shares over the last two years have been less pronounced than one would have expected in light of historical experience and the poor level of cost competitiveness. This is thought to have been due, at least in part, to weak domestic demand, which has hardened the resolve of exporters to maintain markets abroad by reducing profit margins.

Non-oil import volume rose by about 1 1/2 per cent in 1981 and is estimated to have risen again by over 5 per cent in 1982. The volume of non-oil imports has been extremely responsive to the rise in domestic demand. In the early phase of the pickup in aggregate demand--that is, in the second half of 1981--much of the turnaround was due to inventories, which usually have a large import content. In the current year, the demand for consumer durables has been relatively strong. Substantial import penetration has resulted as, at least in the short period experienced thus far, the domestic supply response has been weak.

On the invisibles account, the balance on services, in particular on tourism, is thought to be responsive to relative price developments; but interest, profits, and dividends (IPDs) are sensitive also to world financial and economic conditions. The foreign assets of the United Kingdom have a large equity component, so that profits and dividends play an important part in determining inflows. Foreign liabilities, on the other hand, are to a larger extent in the form of public and banking sector debt, so that outflows are more interest rate sensitive.

The authorities estimate that the surplus on services in 1982 will remain approximately at the 1981 level of about £4 billion. The surplus on IPDs was estimated to be slightly lower than in 1981, while the deficit on transfers was expected to be slightly smaller, owing largely to reduced net transfers to the EC. The overall current account surplus was estimated to be reduced from about £6 billion (2 1/2 per cent of GDP) in 1981 to about £4 billion (1 1/3 per cent of GDP) in 1982.

On the capital account, the ending of exchange controls in 1979 made it possible for domestic financial intermediaries to adjust the currency composition of their portfolios. This adjustment was not instantaneous, but spread over a number of years. On average, nonbank financial institutions now reportedly seek to hold about 15 per cent of their portfolios in foreign currency-denominated assets. Before the fall in the effective value of sterling in the latter half of November, the share of foreign currency-denominated assets held by these institutions amounted to about 12 per cent of their portfolios. In the first ten months of 1982, about a quarter of new portfolio investment by nonbank financial institutions was in foreign assets. Thus, although portfolio capital is obviously sensitive to interest rates and exchange rate expectations, it is possible to identify some continuing trends. These trends are also evident in direct investment abroad, which has risen since about 1977. Overall, nevertheless, if the current account surplus is to fall further, the capital account deficit will correspondingly have to be reduced.

In 1981 net disbursements of official development assistance amounted to £1.1 billion, equivalent to 0.44 per cent of GNP. The substantial increase over the 1980 total of £800 million, or 0.35 per cent of GNP, was due chiefly to new issues of promissory notes in favor of the International Development Association. Net aid in the government spending plans is budgeted to increase by some 8 per cent in 1983/84. The Government believes that trade, external private investment, and lending are as important as aid in development. In 1981 private flows from the United Kingdom to developing countries totaled £3.7 billion, of which a substantial part was a recycling of foreign currency deposits by banks resident in the United Kingdom. Combined official and private flows to developing countries amounted to almost £5 billion in 1981, equivalent to almost 2 per cent of GNP.

## III. The Policy Discussions

There was agreement between the staff team and the authorities on the need for continued firmness in the application of financial policy. It was accepted that, with the current structure of costs and prices, even a modest upturn in domestic demand in 1983 would rapidly lead to the elimination of the external current account surplus. A further improvement in competitiveness would therefore be required before the benefits of the strategy, in terms of sustained growth in output and employment, could be fully realized. The authorities do not have an exchange rate target but, given their commitment to continued progress in reducing the trend rate of inflation, they would not welcome a rapid fall in the value of sterling. Meanwhile, labor market conditions should be made more amenable to further progress in reducing relative unit labor costs, and this can help, in time, further to improve competitiveness.

### 1. External policies

There appeared to be a widespread consensus across the political spectrum that, owing chiefly to excessive labor costs, a weakening of the external position would accompany a resumption of growth. Opinions differed, however, on what to do about that problem.

At one extreme, a rapid expansion of demand was advocated in association with import controls, rather than exchange depreciation, to protect the balance of payments. It was not clear to the staff team how the export sector could be protected from the cost-increasing effects of import restrictions without in fact simulating a depreciation of the currency. The authorities, in any event, continue to resist mounting protectionist pressures and to affirm their support for free and fair trade on a reciprocal basis. They noted that, at a recent meeting of GATT, the United Kingdom had, with other EC countries, emphasized a need for realism. They had entered a reserve against a proposal to link the study of agricultural trade with a commitment to renegotiate the fundamental structure of this trade. However, seen against the background of world recession, the outcome of that meeting was presented as a recommitment to an open trading system.

An opposite view on how to respond to external weakness favored a substantial depreciation of sterling together with a reduction in the value-added tax to offset its immediate price effects. The staff team was concerned about the possible impact effects of a large depreciation associated with a relaxation of fiscal discipline. To engineer a substantial depreciation would require a commensurate easing of monetary policy and would probably reignite inflationary expectations, particularly in the labor market, leaving very little net effect on competitiveness. The authorities for their part were not prepared to take such risks. An incomes policy aimed at containing nominal wage demands in the face of rising prices would be difficult to negotiate and, in any case, would create distortions. For this reason, the problem of international competitiveness could best be dealt with in the context of existing policies.

The authorities took a middle view on the exchange rate. They remain committed to financial policies, including monetary and exchange rate policies, designed to put steady downward pressure on price inflation. Sterling depreciation is not ruled out in this framework but will have to be carefully limited. The effective exchange rate has in fact depreciated at an average annual rate of just over 7 per cent in the last two years. Monetary restraint has at the same time encouraged a steady moderation of increases in unit labor costs to help improve the competitive position of the economy as labor begins to price itself back into employment. In addition to persisting with financial restraint, the authorities have also begun to introduce reforms in the legal and institutional setting of labor-management negotiations to underpin long-term gains in competitiveness.

Intervention in the exchange market is generally limited to smoothing operations that do not seek to reverse the direction of market forces. During most of 1982, official intervention in the foreign exchanges was small. Toward the end of the year, however, there was a stepping-up of intervention, which resulted in an underlying reduction in net reserves of about US$1.2 billion in the last quarter. Much of this intervention took place in relatively thin markets in December.

2. Monetary policy

The MTFS was last restated in the budget in March 1982. Two factors were then taken into account. There was first the difficulty experienced in the short-run control of sterling M3 (£M3). Second, there was the recognition that, despite substantial increases in £M3, money had been tight enough to raise real rates of interest to levels that were extraordinarily high, given the depth of the accompanying recession. Accordingly, the target for money growth in 1982/83 was raised from the initial tentative range of 5-9 per cent to 8-12 per cent, and the set of monetary aggregates to be used as guides in the formulation of policy was broadened (Chart 4). Along with £M3, narrow money (M1), and the broad measure of private sector liquidity (PSL2) were included as target variables. In addition, the authorities stated that exchange rate and interest rate developments would be regarded as supplementary indicators of financial conditions.

During the period from February through December 1982, all the targeted aggregates have stayed inside the 8-12 per cent growth range, although narrow money has recently accelerated in response to falling interest rates and lower inflation. However, commercial bank lending, especially to the personal sector, has grown more rapidly than expected, and at times the Government has chosen to overfund the PSBR outside the banking system, while reducing net borrowing from the banking system in order to contain monetary growth within the target range. With sharply falling inflation, real interest rates have remained relatively high, although they have declined somewhat in recent months. The exchange rate of sterling in effective terms also fell markedly in November-December 1982. Thus, although the growth in the monetary aggregates has remained within the target range, the supplementary indicators of monetary stringency suggest that financial pressures may have eased somewhat toward the end of 1982, at least in relation to those in other major countries.

The official projections for the 1982/83 fiscal year envisage a growth rate of less than 1 per cent in real GDP and of 8 1/2 per cent in nominal GDP. More relevant, perhaps, for the transactions balance is the growth of total domestic demand projected at 2 1/2 per cent in real terms and almost 10 per cent in nominal terms. Even though the income velocity of narrow money is likely to have declined in response to the reduced rate of inflation and lower interest rates, the 8-12 per cent target range in this period would seem adequate to accommodate the projected economic developments.

For the next fiscal year, 1983/84, the illustrative monetary target ranges were set at 7-11 per cent or 1 percentage point below those for the current year. Official projections show a growth rate of GDP of 2 per cent in real terms and 7 per cent in nominal terms, while the growth of real domestic demand is projected at 3 per cent and nominal demand at 8 1/2 per cent. The authorities project that net public sector borrowing from the banking system during 1983/84 will be a very small fraction of the 8 1/2 per cent increase estimated for £M3, while external influences are expected to be contractionary. Thus, bank lending to the private sector is to be the only major source of the increase in broad money. In recent years, however, bank lending has been extremely difficult to predict. The Treasury forecast assumes both £M3 and PSL2 to remain near the middle of the target range, while M1 would grow at a rate of 13 per cent in response to changes in the velocity of circulation. These monetary trends are thought to be consistent with a continuing fall in the rate of inflation and some further downward movement in interest rates.

3. Fiscal policy

Fiscal policy in 1981/82 was considerably more restrained than initially envisaged, with the PSBR, budgeted at £10 1/2 billion (4 1/4 per cent of GDP), turning out to be below £9 billion (3 1/2 per cent of GDP). In the current fiscal year, Treasury representatives thought it likely that the PSBR would again be lower than the budget projection (Chart 5).

Aggregate spending in 1982/83 was now expected to be about £1 1/2 billion below budget, owing partly to lower inflation than anticipated and partly to lower capital expenditure by local authorities and public sector corporations. Aggregate receipts were likely to be about £1 billion less than initially projected. This was due chiefly to the bringing forward of the reduction in national insurance surcharge rates (surcharges paid by companies on social insurance contributions), to the deferment of duties payable on spirits, and to a lower level of prices and economic activity than had been projected. The March 1982 budget had estimated the PSBR at £9 1/2 billion or 3 1/2 per cent of GDP. In the Autumn Statement to Parliament, the PSBR had been projected at £9 billion or 3 1/4 per cent of the reduced nominal GDP estimate. At the time of the discussions, the authorities thought that even these estimates seemed somewhat pessimistic, and that the PSBR would probably turn out to be in the £8-9 billion range, or around 3 per cent of GDP.

While the Government's objective of reducing the PSBR in terms of GDP had largely been realized, the objective of reducing the ratio of public expenditure to GDP had not thus far been met. Indeed, the ratio increased from 41 per cent in 1978/79 to almost 45 per cent in 1981/82. Within the aggregate of government spending, the authorities were concerned about deviations from official intentions in both directions. On one side, the authorities observed that capital expenditure by local authorities was again considerably below budget in the current year and that they were trying to encourage local authorities to raise spending to the levels projected. It was now likely that less than three quarters of the £4 billion cash limit for local authority capital expenditure in 1982/83 would be used, and capital expenditures by public sector corporations were also again likely to be substantially below budget estimates. On the other side, certain elements of current expenditure had proved difficult to control.

The public sector spending plan for 1983/84, announced in the Autumn Statement to Parliament, promised continued fiscal austerity. The planning total had been reduced by about £1/2 billion from the indicative figure published at the time of the last budget as the Government had resisted strong pressures for increased spending by various departments. Additional spending of £260 million was allocated for new special employment measures and more funds were provided for urban renewal, housing, law and order, and health services. The provision for defense was also increased by about £600 million to meet costs associated with the defense of the Falkland Islands. All of these increases were accommodated within the contingency reserve which as a result had been reduced from £4 billion to £1 1/2 billion. The increase in the public service wage bill for 1983/84 is expected to be accommodated within a 3 1/2 per cent cash provision. In cost terms--that is, adjusted by the GDP deflator--the planning total for expenditure in 1983/84 is lower than the initial estimate for the current year. On current projections, the ratio of planned public expenditure to GDP should fall in 1983/84.

As noted earlier, last November the Government announced a 1 percentage point reduction, for 1983/84, in the employers' national insurance surcharge (NIS). 1/ This will reduce the NIS from the 2 1/2 per cent set in 1982/83 to 1 1/2 per cent in 1983/84. In addition, half of this reduction was brought forward into the current year for private sector employers, so that the rate of NIS would effectively be 2 per cent rather than 2 1/2 per cent in the current fiscal year. The intended effect of these measures is to cut employment-related business costs by £350 million net in the current fiscal year, and by £700 million net in 1983/84. At the same time as the surcharge was reduced, increases in national insurance contributions for both employers and employees of 1/4 percentage point were announced for 1983/84. This is the same as an equivalent increase in income tax for employees and effectively reduces the relief from the NIS for employers by 1/4 percentage point.

The Government had made clear its desire to reduce the PSBR as a percentage of money GDP over a number of years, but a figure for the ultimate objective had not been announced. Returning to the position of the 1960s suggested a PSBR of perhaps 2 1/2 per cent of GDP. The staff team noted that in the Autumn Statement the PSBR for 1983/84 had been projected at £8 billion or 2 3/4 per cent of GDP. There would thus be a further 1/2 percentage point reduction in relation to GDP from the official projection for the current year. Implicit in this estimate, however, was a reduction in taxation amounting to £1 billion in 1983/84, which in the official forecast was conventionally assumed to take the form of a personal income tax reduction.

The U.K. representatives explained that the £1 billion fiscal adjustment was purely a matter of arithmetic and did not reflect any policy commitments. Given projected receipts and expenditure and the target for the PSBR of 2 3/4 per cent of GDP, fiscal adjustment of £1 billion had emerged. The actual budgetary changes for 1983/84 might well be more or less than this figure, the policy decision had yet to be made.

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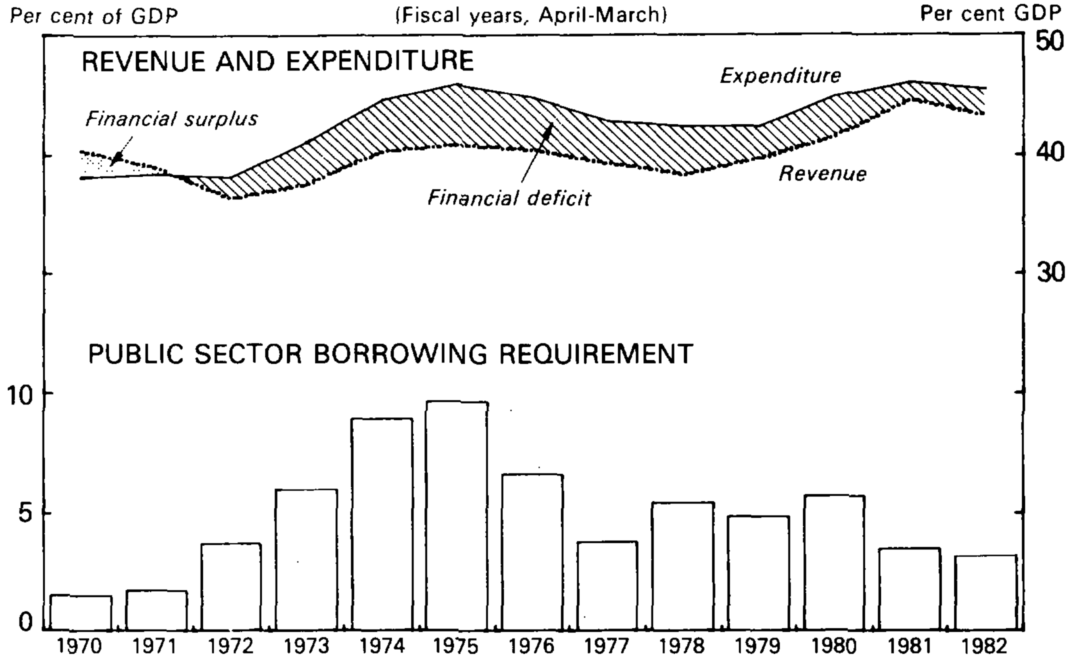
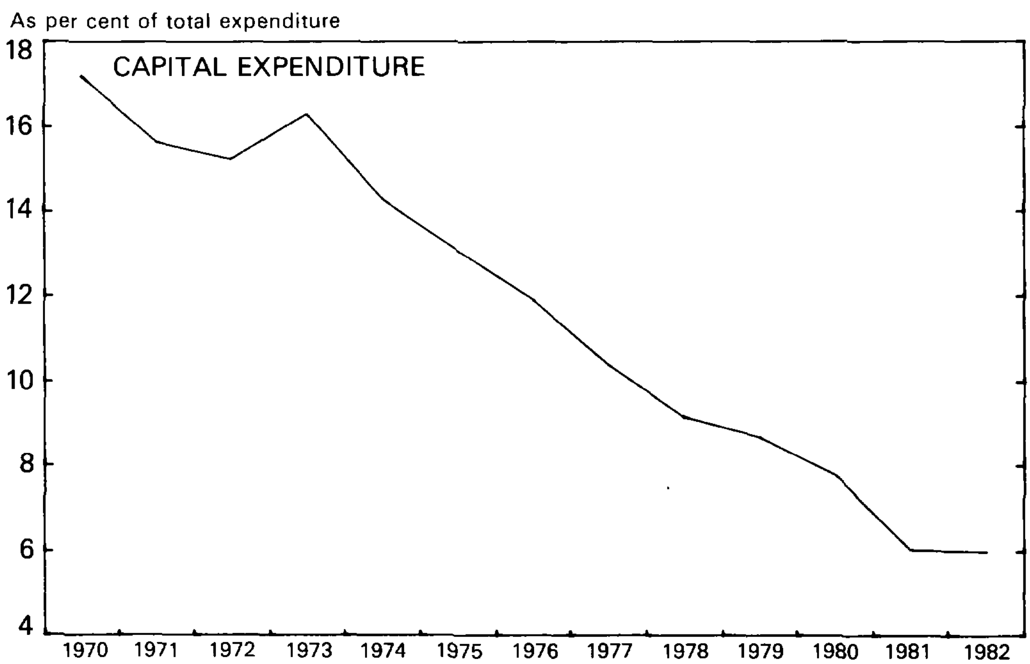
1/ This is a tax levied on employers, based on national insurance paid for employees, which is often characterized as a tax on employment.

CHART 5

UNITED KINGDOM

# GENERAL GOVERNMENT




Sources: Central Statistical Office, Financial Statistics and Economic Trends; H.M. Stationary Office, Financial Statement and Budget report, 1982/83; and data provided by the authorities.

The U.K. representatives thought it not impossible that a lower PSBR with given monetary policy would, by lowering interest rates and the value of sterling, provide more stimulus than a tax cut. On balance, however, they thought that a reduction in taxation would probably be more effective and, in particular, that a reduction in the NIS would be more convincing to industry than a lowering of interest rates that might be brought about by an equivalent fall in the PSBR. Companies would regard a lowering or abolition of the NIS as permanent, while interest rate movements might be perceived as transitory. It was pointed out, however, that the magnitude of any potential tax cut reflected in the current projections--that is, about £1 billion--was probably too small to have much effect at all, and, similarly, that a reduction of the PSBR of this magnitude would probably have very little effect on interest rates.

4. Labor market policies

The philosophical consideration that motivated government policy was a commitment to the free operation of market forces within an equitable legal framework. Policies to expose to competition industries formerly controlled by government monopolies, to sell public sector corporations to private interests, and to curtail the monopoly power of unions in the labor market were all part of the same overall strategy.

The Employment Act of 1980 sought to redress an imbalance in the legal system in favor of trade unions. It restricted "closed shop" practices (that require union membership as a condition of employment), established a code of practice on picketing, made persons involved in secondary action (such as picketing other than at their own place of work) liable to be sued for damages, and encouraged union ballots by making funds available for them under certain conditions. The Employment Act of 1982 built on and extended these reforms. It provided for regular ballots on existing closed shops and increased compensation for those who refused to join. It introduced a narrower definition of lawful industrial disputes and made unions liable for the actions of their officials where disputes fall outside this new definition. Clauses in commercial contracts requiring union labor only were made unlawful and, under the Act, employers are now allowed to dismiss strikers who remain out after a general return to work. In addition, government funds have now been made available for secret ballots on wage offers in order to ensure that the union positions on these issues are reflective of their membership in general.

Both Employment Acts were intended to remove some of the main excesses of trade union power, but are, as yet, largely untried. Their provisions leave the balance of power between employers and employees in the most typical industrial disputes on wages or working practices largely unaffected. Certain changes in the institutional setting have, however, had an important psychological effect. The supplementary benefits that strikers can claim for their families have been reduced, and the tax rebates available to strikers can no longer be drawn at the onset of strikes. The Government is committed to further action that will tilt the present balance in industrial relations more in favor of employers. A consultative paper on means to ensure democratic decision-making in trade unions will be issued shortly, and legislation covering trade union elections is also in prospect.

The authorities explained that in the past there had been three overriding considerations in pay bargaining: first, the rate of inflation; second, the "going rate" which was influenced to a large extent by settlement levels in other sectors; and third, the objective of unions to maintain wage relativities. Over the last three pay rounds, these three factors had become less important, especially in the private sector. A principal consideration now is the individual concern about the health of the industry and the fear of pricing workers out of the job. An illustration was the recent vote of the coal miners against a proposed strike. There were also indications that labor negotiators were coming to accept a low and stable rate of inflation as a likely prospect. In addition, there seemed to be a move away from national pay bargaining to company level bargaining. The Government was also doing its best to reinforce greater realism by setting rigorous cash limits in the public services, which could be expected to influence pay negotiations generally. For the fiscal year 1983/84, the cash limit included an assumption of an increase of 3 1/2 per cent in the public service wage bill.

The U.K. representatives observed that from the mid-1970s until the end of the decade, there had been a marked slowdown in the recorded growth of productivity. Part of this may have been associated with inflexible labor markets at a time of structural change and part perhaps with successive increases in real energy prices since 1973. Other explanatory factors may have included a more rapid and volatile inflation in the 1970s and increased regulatory burdens on industry. The fall in productivity from the last peak in the economic cycle in 1979 was much smaller than would have been projected by extrapolation from the past. Output per man-hour in manufacturing fell just over 1 per cent between the first half of 1979 and the end of 1980. By the second quarter of 1982, however, it had increased by 11 per cent. Past relationships suggest that productivity has behaved exceptionally since the end of 1979. By the second half of 1982, the level of productivity in manufacturing was some 8 per cent higher than expected on the basis of extrapolations of the experience of the late 1970s. For the private nonmanufacturing sector, productivity was about 2 1/2 per cent higher than would have been projected. The U.K. representatives believed that under the severe financial pressure and depressed profit situation of the last two years, firms undertook a massive "shake-out" of labor, realizing productivity gains that had long been possible but had not been effected because of potential labor resistance. There are indications of a new realism in labor markets, both on the part of employers and employees, that should help sustain productivity growth during the recovery.

While the Government had focused a great deal of attention on subjecting pay negotiations to market forces, it had not been insensitive to the distress faced by the unemployed. In addition to the schemes already in place aimed at helping the unemployed, two new programs have recently been initiated--the community program, and the job-splitting program. 1/ The Government was particularly concerned about the high level of youth unemployment, and a number of schemes sought to alleviate this problem. Two basic objectives were being pursued in parallel: training and realistic pricing of labor. The Young Worker's Scheme pays employers a subsidy for employing workers under 18 at less than £45 a week. It thereby provides employers with a financial incentive to employ and train young workers at realistic wage rates, while subjecting young people to experience in work situations. In 1983 this scheme, together with the Youth Opportunities Program, is to be incorporated in an expanded Youth Training Scheme, guaranteeing a full year's training to young people leaving school at the minimum age without a job.

In summary, the objectives of the Government's labor market policies were to ensure realistic pricing of labor so as to re-establish the competitiveness of U.K. industry in the world market, and to establish a productive and properly trained work force. It was thought that policies aimed at these objectives would over time reduce unemployment.

## IV. The Economic Outlook

There is broad similarity between the official Industry Act forecasts for 1983 made public in November and the projections made by the staff in the context of the World Economic Outlook exercise. The staff projections are slightly less sanguine with respect to growth and inflation, but broadly similar on the external current account.

In the official forecasts for 1983, private consumption is projected to rise by almost 2 1/2 per cent, government consumption by 1 per cent, and fixed investment by about 5 per cent. Changes in stocks are projected to contribute almost 1/2 per cent to real GDP growth, while the change in the foreign balance is expected to reduce GDP growth by about 1 1/2 per cent. Thus, while real total domestic demand rises by almost 3 per cent, real GDP is forecast to increase by only 1 1/2 per cent.

The staff projections envisage a somewhat slower growth in consumption--that is, about 2 per cent--based on slightly less buoyant growth of personal disposable income. Partly in response to lower consumption demand, and perhaps an overall outlook that is less sanguine, the staff projections envisage a growth of only about 3 per cent in gross fixed investment. Stockbuilding is projected to contribute a little less to GDP growth, and the change in the foreign balance is expected to have a slightly smaller negative impact than in the official projections. Thus, in the staff forecasts, real total domestic demand is projected to rise at a rate of 2 1/4 per cent, and real GDP to grow by only 1 per cent.

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1/ Details of these programs may be found in the recent economic developments paper, to be circulated shortly.

On inflation, the authorities expect the 12-month rate of increase in the retail price index to fall to about 5 per cent in the spring of 1983 and to remain at about that rate through the end of the year. The staff expect retail price inflation to be slightly above 6 per cent in 1983 on average, and the 12-month rate at the end of the year not to be substantially below this figure. The differences are slight, but they may perhaps reflect the fact that the staff projections incorporate the changes in the value of sterling in late November and early December.

Both sets of projections are pessimistic with respect to manufacturing output, which continues to be substantially below the level achieved in 1979; however, both show rather promising reductions in the rate of increase in unit labor costs in manufacturing from 4 1/2 per cent in 1982 to below 3 per cent in 1983. The authorities expect productivity growth (defined as the change in output per head) in the economy as a whole (excluding North Sea oil) to continue at almost 3 per cent in 1983; both the staff and the official forecasts envisage a further worsening of unemployment in 1983.

On the external side, although the Fund projections are based on slightly higher market growth assumptions, there is virtually no difference in export volume projections. Despite an increase of about 3 per cent in the volume of oil exports, total export volume is projected to remain virtually unchanged. This implies a continuing reduction in export market shares. The official forecasts, in line with their stronger growth in total domestic demand, envisage a higher rate of import volume growth--that is, 6 1/2 per cent as against slightly under 6 per cent in the staff projections. Both sets of projections estimate the deficit on trading account in 1983 at about £3 1/2 billion and the current account surplus at below £1/2 billion.

## V. Staff Appraisal

The control of inflation has remained the pre-eminent objective of financial policy in the United Kingdom, in the expectation that it will establish a firm basis for sustained growth in the medium term. A medium-term financial strategy has been broadly adhered to and its credibility is now generally established. As a result, some of the returns to it have begun to come through much as one might have expected. Some costly imbalances remain; but first the main achievements may be noted.

The rate of inflation has fallen dramatically. From a peak of 21 per cent in mid-1980, the 12-month rate of increase in retail prices has come down to below 7 per cent and is expected to remain at about 6 per cent in 1983. During 1982 the abatement of inflation has been rapid, and it has been associated with a very steep fall in short-term as well as long-term interest rates. Wage inflation is also coming down, though regrettably not as fast as retail price inflation.

Much of the deceleration of price inflation can be traced to monetary restraint. To be sure, the initial quantitative money growth targets had to be adjusted as experience was gained with the operation of the financial strategy. Nevertheless, downward pressure has been maintained and monetary expansion has abated. The wider aggregate (£M3) expanded by 10 1/2 per cent during 1982, compared with over 13 per cent the year before. Growth of the narrow aggregate (M1) increased from 7 1/2 per cent to 11 per cent, reflecting the upward pressure from declining interest rates.

The decline in interest rates has also been rapid--the three-month interbank rate fell to about 10 per cent in December 1982, compared with 15 per cent at the beginning of the year. Setting indicative targets for the PSBR, consistent with the monetary targets, played a large role in making this progress possible. Here, too, modifications were required as circumstances changed, but even so, the PSBR in relation to GDP has been brought down from nearly 6 per cent in 1980/81 to just over 3 per cent in 1982/83.

The rapid fall in the inflation rate, set against the narrow monetary aggregates in particular, is beginning to yield new growth in the real money stock that is expected to accelerate next year. This should provide the room--as well as part of the stimulus--for the sustained recovery of economic activity that has been the objective of the counter-inflationary strategy. Domestic demand in real terms has resumed growing at a rate of about 2 1/2 per cent per year. Unfortunately, poor levels of profitability and competitiveness continue to limit the share of demand met by domestic producers, and the rise of unemployment is therefore unlikely to be checked soon.

The lag in the deceleration of earnings is regrettable mainly for this reason. To be sure, the increase in productivity, though mainly the consequence of a large-scale shedding of labor, has also been significant. Even so, however, the deceleration in the growth of wage costs has not been sufficient to restore the competitiveness of British products at home or abroad. Measured in local currencies, there has been little change in relative unit labor costs. Much of the increase in demand therefore spills out into imports, while export shares continue to decline in a depressed world market. As a result, the growth in real GDP in 1983 is expected to be only about 1 per cent, while domestic demand is projected to rise at 2 1/4 per cent, of which half a percentage point would be due to fixed investment.

The external balance on current account, though already weaker in 1982 than the year before, is still expected to have registered a substantial surplus in 1982 equivalent to 1 1/3 per cent of GDP. It is, however, likely to disappear altogether during 1983. That prospect undoubtedly contributed to the slide of the pound in November and December 1982, and to the associated increase in interest rates. Sterling depreciated by nearly 10 per cent in effective terms over this period. This development will have eased the competitive constraint on economic expansion, though probably at the cost of arresting the decline in inflation.

As long as exchange rate adjustments are consistent with a continued favorable performance on inflation, monetary policy can be regarded as broadly on track. It seems to the staff important to ensure that this is the case. A low rate of price inflation is still necessary to secure the wage restraint without which depreciation of the currency would in any case have little effect on competitiveness. Further moderation in the growth of earnings remains a crucial element both in the control of inflation and in the improvement of competitiveness on which its reward depends.

With monetary policy balanced in this way, there is little scope for changing its stance in either direction. Even a steady stance may require occasional adjustments in the quantitative targets set for the main monetary aggregates. Nominal GDP is expected to rise by 8 per cent next year. With indicative limits of 7-11 per cent, the official forecasts show a 13 per cent rise in M1, but a rise in £M3 and PSL2 of just over 8 per cent, reflecting a switch back to transactions balances as inflation and interest rates come down. A separate limit for M1 is therefore being considered. The staff prefer that the discrepancy be left to stand as an indicator of concern, as it was in similar circumstances for £M3.

Restraints on the PSBR continue to ensure that its financing will not place undue upward pressure on interest rates. Though interest rates are still relatively high in real terms, a major decline would risk an inflationary depreciation of sterling. The staff are therefore prepared to accept the present PSBR projection of 2 3/4 per cent of GDP as within the appropriate range for 1983. If room is found within this limit for a small fiscal adjustment at budget time, it should be used to improve the cost competitiveness of industry.

The staff regard the efforts to contain the increase in the public sector wage bill to 3 1/2 per cent in 1983/84 as important in terms of the narrow fiscal objective and, more generally, as a signal to wage negotiations in other sectors. Developments in the legal framework of pay bargaining and industrial relations have also helped to promote a more pragmatic attitude in the labor market. The staff welcome the actions already taken and support the intention of further action in this field.

As long as poor export performance and high import penetration continue, pressures for protection are likely to increase. The staff are concerned by the strength that these pressures have already acquired particularly where other countries seem slow to open their markets to British exports. The common interest argues against responding in kind. Similarly, the staff would urge the authorities to resist any pressures for scaling down official development assistance despite the sizable private flows that also deserve recognition.

Table 1. United Kingdom: The Medium-Term
Financial Strategy: Revised Figures

(In billions of pounds; or percentage changes)

| | 1980/81 1/ | 1981/82 1/ | 1982/83 2/ | 1983/84 2/ | 1984/85 3/ |
|---|---|---|---|---|---|
| Money growth rates: | | | | | |
| Sterling M3 | 20.0 | 14.4 | 8-12 | 7-11 | 6-10 |
| (Original projections) | (7-11) | (6-10) | (5-9) | (4-8) | |
| M1 | 9.4 | 9.2 | 8-12 | 7-11 | 6-10 |
| PSL2 | 14.1 | 12.1 | 8-12 | 7-11 | 6-10 |
| General government expenditure | 107.9 | 120 | 130 1/2 | 136 1/2 | 148 |
| General government receipts | -94.0 | -111 1/2 | -120 1/2 | 129 1/2 | -143 |
| Implied fiscal adjustment 4/ | -- | -- | -- | +1 | +2 |
| Public sector borrowing requirement 5/ | 13.2 | 9 | 9 | 8 | 6 1/2 |
| (As per cent of GDP at market prices) | (5.7) | (3 1/2) | (3 1/4) | (2 3/4) | (2) |

Source: Financial Statement and Budget Report, 1982/83, and Autumn Statement, 1982.

1/ For 1980/81 and 1981/82 the monetary growth rates are the actual most recent data for February-February periods, and the fiscal data are the actual outturns.
2/ As revised in the Autumn Statement. 1982.
3/ Based on the March 1982, Financial Statement and Budget Report.
4/ + means lower taxes or higher public expenditure than assumed in the preceding lines of the table.
5/ The PSBR does not equal the difference between general government expenditure and receipts because it also includes financial transactions and the public corporation borrowing.

Table 2. United Kingdom: Domestic Developments and Forecasts

(Percentage change from a year earlier)

| | 1979 | 1980 | 1981 | 1982 1/ | 1983 1/ |
|---|---|---|---|---|---|
| Demand and output (at 1975 prices) | | | | | |
| Private consumption | 4.9 | -- | 0.3 | 0.5 | 2.3 |
| Government consumption | 1.8 | 1.9 | 0.3 | 2.0 | 1.0 |
| Investment | 0.9 | -2.8 | -8.2 | 3.1 | 5.1 |
| Public | -2.5 | -5.9 | -17.6 | -4.3 | 3.3 |
| Private residential | -13.3 | -16.1 | -15.5 | 12.7 | 14.2 |
| Other private | 5.9 | 1.1 | -2.2 | 4.7 | 1.7 |
| Stockbuilding 2/ 3/ | 0.9 | -3.1 | -0.4 | 0.9 | 0.5 |
| Total domestic demand | 4.4 | -3.2 | -1.6 | 2.1 | 2.9 |
| Foreign balance 2/ | -2.4 | 1.1 | -0.5 | -1.6 | -1.5 |
| GDP at market prices | 2.0 | -2.1 | -2.2 | 0.5 | 1.4 |
| Industrial production | 2.4 | -6.4 | -5.1 | 0.5 4/ | ... |
| Manufacturing production | 0.3 | -8.5 | -6.3 | -0.5 4/ | ... |
| Prices, incomes, and employment | | | | | |
| Deflator for GDP at market prices | 15.1 | 18.9 | 12.7 | 10.0 | 7.0 |
| Retail prices | 13.4 | 18.0 | 11.9 | 8.7 | ... |
| Average earnings | 15.5 | 20.7 | 12.9 | 9.7 5/ | ... |
| Unit labor costs in manufacturing | 13.8 | 22.1 | 8.5 | 4.5 | ... |
| Unemployment rate (excluding school leavers) | 5.4 | 6.8 | 10.6 | 12.3 | ... |

Sources: Central Statistical Office, Economic Trends; and information provided by the U.K. authorities.

1/ Official forecasts.
2/ Contribution to GDP growth.
3/ Including the compromise adjustment of GDP.
4/ First three quarters of 1982 over 1981 average.
5/ First ten months of 1982 over 1981 average.

Table 3. United Kingdom: External Developments

| | 1978 | 1979 | 1980 | 1981 | 1982 Estimated 1/ | 1983 Projected 1/ |
|---|---|---|---|---|---|---|
| | | | | (In billions of pounds) | | |
| Balance of payments | 35.1 | 40.7 | 47.4 | 51.1 | 54.4 | 57.1 |
| Exports, f.o.b. | 35.1 | 40.7 | 47.4 | 51.1 | 54.4 | 57.1 |
| Imports, f.o.b. | 36.6 | 44.1 | 46.2 | 48.1 | 53.7 | 60.6 |
| Trade balance | -1.5 | -3.5 | 1.2 | 3.0 | 0.7 | -3.5 |
| Services, IPD, and private transfers | 4.2 | 4.7 | 3.5 | 4.8 | 4.4 | 5.1 |
| Official transfers | -1.7 | -2.1 | -1.8 | -1.7 | -1.4 | -1.4 |
| Current account balance | 0.9 | -0.9 | 2.9 | 6.1 | 3.7 | 0.2 |
| Investment and other capital 2/ | -2.0 | 2.8 | -1.5 | -6.8 | -3.0 3/ | ... |
| Balance for official financing | -1.1 | 1.9 | 1.4 | -0.7 | -0.4 3/ | ... |
| Gross reserves, end period (in billions of US$) | 17.0 | 23.0 | 27.5 | 23.3 | 17.0 | ... |
| | | | | (Percentage change) | | |
| Merchandise export volume | 2.6 | 3.4 | 1.8 | -0.9 | 0.2 | -0.2 |
| Merchandise import volume | 4.4 | 11.5 | -4.3 | -0.4 | 6.0 | 6.5 |
| Terms of trade | 5.7 | 0.4 | -2.4 | -1.7 | -0.9 3/ | ... |
| Effective exchange rate | 0.4 | 7.1 | 10.1 | -0.8 | -5.1 | ... |
| Relative unit labor costs (adjusted for exchange rate changes) 4/ | 6.7 | 15.8 | 22.6 | 6.2 | -3.1 | ... |

Sources: Central Statistical Office, Economic Trends; IMF, International Financial Statistics; and information provided by the U.K. authorities.

1/ Official estimates and projections.
2/ Including balancing item and allocation of SDRs.
3/ January to September.
4/ Relative unit labor costs are normalized for cyclical variations in productivity.

## Fund Relations with the United Kingdom

| | | |
|---|---|---|
| Date of membership | December 27, 1945 | |
| Status | Article VIII, as from February 15, 1961 | |
| Fund holdings of pounds sterling | As of December 31, 1982 | SDR 2,979.5 million (67.9 per cent of quota), excluding SDR 51.5 million held under the oil facility; SDR 3,031.0 million (69.1 per cent of quota) including holdings under the oil facility |
| SDR position | As of December 31, 1982 | SDR 1,060.7 million (£5 per cent of net cumulative allocation) |
| Gold distribution (Four distributions) | | 2,396,322.177 fine ounces |
| Exchange system | The U.K. authorities do not maintain margins in respect of exchange transactions and exchange rates are determined largely on the basis of demand and supply conditions in the exchange markets. However, the authorities intervene when necessary in order to smooth out disruptive fluctuations in exchange rates. The exchange rate of sterling on December 31, 1982 was £1 = SDR 1.464; £1 = US$1.615; on the same date the MERM index for sterling (1975 = 100) was 83.95 | |
| Last consultation | The staff report for the 1981 Article IV consultation (SM/82/19, 1/28/82) was considered by the Executive Board on February 19, 1982 | |

APPENDIX II
SM/83/18
Corrected: 2/25/83

## United Kingdom—Basic Data

### Area and population

| | |
|---|---|
| Area | 94,216 sq. miles |
| Population (mid-1981) | 55.9 million |
| Working population (mid-1982) | 25.7 million |

| Composition of GDP in 1981, at current prices | In billions of pounds | Distribution in per cent |
|---|---|---|
| Private consumption | 151.0 | 60.8 |
| Public consumption | 55.2 | 22.2 |
| Total investment (including stockbuilding) | 35.2 | 14.2 |
| Total domestic demand | 241.4 | 97.2 |
| Exports of goods and services | 67.9 | 27.3 |
| Imports of goods and services | -60.9 | -24.5 |
| GDP at market prices (expenditure estimate) | 248.4 | 100.0 |

| Selected economic data, average change in per cent | 1980 | 1981 | 1982 Estimate |
|---|---|---|---|
| Real GDP (at market prices, average estimate) | -2.1 | -2.2 | 0.5 |
| Manufacturing production | -8.5 | -6.3 | -0.5 |
| Average earnings | 20.7 | 12.9 | 9.7 |
| Retail price index | 18.0 | 11.9 | 8.7 |
| M1 1/ | 6.8 | 7.7 | 11.2 |
| Sterling M3 1/ | 20.2 | 13.1 | 10.4 |
| Rate of unemployment (in per cent) | 6.8 | 10.6 | 12.3 |

| Public sector accounts, in billions of pounds | 1980/81 Outturn | 1981/82 Outturn | 1982/83 Estimate |
|---|---|---|---|
| General government receipts | 96.4 | 113.2 | 120.0 |
| General government expenditure | 104.4 | 116.9 | 126.0 |
| Financial balance | -8.0 | -3.7 | -6.0 |
| Public corporations' financial balance | -2.4 | -1.9 | -2.0 |
| Public sector net lending | -2.8 | -3.2 | -1.0 |
| Public sector borrowing requirement | -13.2 | -8.8 | -9.0 |
| (In per cent of GDP) | 5.7 | 3.5 | 3.2 |

| Balance of payments, in billions of pounds | 1980 | 1981 | 1982 Estimate |
|---|---|---|---|
| Exports | 47.4 | 51.1 | 54.4 |
| Imports | 46.2 | 48.1 | 53.7 |
| Trade balance | 1.2 | 3.0 | 0.7 |
| Net invisibles | 1.7 | 3.1 | 3.0 |
| Current account balance | 2.9 | 6.1 | 3.7 |
| Investment and other long-term capital | -1.0 | -6.2 | -2.0 2/ |
| External sterling liabilities | 3.8 | 2.7 | 4.1 2/ |
| Trade credits and other short-term capital 3/ | -4.3 | -3.3 | -5.0 2/ |
| Balance for official financing | 1.4 | -0.7 | -0.4 2/ |
| Gross reserves, official basis (US$) | 27.5 | 23.3 | 17.0 |
| Gross reserves, IFS basis (SDRs) | 16.9 | 13.8 | ... |
| Average effective exchange rate index (1975 = 100) | 96.1 | 95.3 | 90.5 |

1/ End-period.
2/ January to September.
3/ Including balancing item and allocation of SDRs.