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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 83/35

10:00 a.m., February 23, 1983

W. B. Dale, Acting Chairman

Executive Directors	Alternate Executive Directors
	J. K. Orleans-Lindsay, Temporary
J. Anson	C. Taylor
	L. E. J. Coene, Temporary
B. de Maulde	A. Le Lorier
A. Donoso	
R. D. Erb	C. Dallara
M. Finaish	
A. H. Habib	Jaafar A.
T. Hirao	T. Yamashita
R. K. Joyce	M. Casey
A. Kafka	
	G. Grosche
G. Lovato	C. P. Caranicas
R. N. Malhotra	V. K. S. Nair, Temporary
Y. A. Nimatallah	
J. J. Polak	T. de Vries
	K. G. Morrell
G. Salehkhou	O. Kabbaj
F. Sangare	E. I. M. Mtei
M. A. Senior	
J. Tvedt	
Zhang Z.	Wang E.

L. Van Houtven, Secretary
B. J. Owen, Assistant

Also Present

African Department: A. Jbili. Asian Department: J. T. Boorman, R. J. Hides. European Department: L. A. Whittome, Counsellor and Director; M. T. Hadjimichael, A. Knobl, H. O. Schmitt, P. van den Boogaerde. Exchange and Trade Relations Department: S. Mookerjee, Deputy Director; G. Belanger, R. Pownall. Fiscal Affairs Department: V. Tanzi, Director; R. D. Kibuka, O. Pettersen. Legal Department: J. M. Ogoola, S. A. Silard. Middle Eastern Department: A. S. Shaalan, Director; A. K. El Selehdar, Deputy Director; G. T. Abed, R. K. Basanti, P. L. Clawson, R. H. Floyd, S. Geadah, S. H. Hitti, B. A. Karamali, S. Kawar, K. Nashashibi, B. K. Short, E. M. Taha, M. Yaqub. Research Department: A. D. Crockett, Deputy Director; C. P. Blackwell, J. M. Boughton, L. U. Ecevit. Secretary's Department: J. C. Corr. Treasurer's Department: A. M. Al-Samarrie. Western Hemisphere Department: J. Ferrán. Advisor to the Managing Director: W. E. Robichek. Personal Assistant to the Managing Director: N. Carter. Advisors to Executive Directors: A. A. Agah, J. R. N. Almeida, C. J. Batliwalla, J. Delgadillo, S. El-Khouri, M. A. Janjua, P. Kohnert, H.-S. Lee, P. D. Péroz. Assistants to Executive Directors: E. M. Ainley, H. Alaoui-Abdallaoui, H. Arias, M. Camara, T. A. Connors, G. Ercel, M. Hull, W. Moerke, Y. Okubo, J. G. Pedersen, G. W. K. Pickering, M. Z. M. Qureshi, J. Reddy, C. A. Salinas, J. Schuijer, D. I. S. Shaw, H. Suzuki, M. Toro, J. C. Williams.

1. YEMEN ARAB REPUBLIC - USE OF FUND RESOURCES

The Executive Directors considered a staff paper on a request by the Yemen Arab Republic for a purchase equivalent to SDR 4.875 million under the Fund's policy on emergency assistance related to natural disasters (EBS/83/26, 2/2/83).

The Acting Chairman noted that the duly authenticated request had not yet been received from the Yemen Arab Republic, probably due to a technical misunderstanding. Accordingly, he proposed that the Executive Board should consider the request for use of Fund resources in principle, and that the formal decision should be taken on a lapse-of-time basis when the formal request could be circulated.

Mr. Finaish informed Executive Directors that he had visited the Yemen Arab Republic shortly after the return of the staff mission. He had found the earthquake damage to be more extensive than had been initially reported; the need for relief supplies remained acute, as indicated in the staff paper. Looking to the medium term, the reconstruction effort would take many years and would require substantial resources. Certainly, the proposed size of the emergency drawing was very small compared with the loss caused by the earthquake.

Mr. Nimatallah said that it was clear from the staff paper that the damage caused to the Dhamar area by the earthquake in December 1982 had been substantial. The immediate task facing the authorities had been to provide the victims with temporary shelter and the basic necessities of life. The long-term task involved resettlement of the displaced people and the reconstruction of housing and infrastructure. Both tasks would entail heavy costs and their realization would require sizable external aid.

He fully supported the request by the Yemen Arab Republic to use the Fund's resources under its policy on emergency assistance to help to finance disaster-related imports, Mr. Nimatallah stated. The Yemen Arab Republic enjoyed a trade and payments system that was free of restrictions, and assistance from the Fund would be of importance in helping the authorities to maintain it at a time when the balance of payments was coming under increasing strain due to the earthquake. The Y.A.R authorities had maintained a close relationship with the Fund, which had provided extensive assistance. Consultations had been conducted on a regular basis, and the next Article IV discussions were scheduled for May, 1983. He was confident that the authorities would cooperate with the Fund in finding solutions to the balance of payments problem.

Mr. Taylor observed that the December earthquake had been a serious disaster and the continued seismic activity would upset the economy over the coming several months. Despite the immediate international assistance received or expected after the earthquake, the cost of emergency imports seemed likely to bear heavily on the country's foreign exchange reserves in 1983. As the staff had stated, the Yemen Arab Republic had negligible exports, and other sources of foreign exchange were described as highly vulnerable. It was therefore clear that the balance of payments problem would be severe in 1983. In the circumstances, the authorities' decision to collaborate with the Fund in finding a solution and in formulating an adjustment program as soon as possible was highly commendable.

The urgency of the balance of payments need and the comprehensive response of the authorities had made him eager to support the request for a purchase, Mr. Taylor stated. He looked forward to a fuller discussion of the authorities' adjustment program at the time of the Article IV consultation, which was to be held in May 1983.

Mr. Dallara said that he was in agreement with the staff appraisal and with the conclusion that the Yemen Arab Republic's request was consistent with Fund practice regarding the provision of financial assistance in cases of natural disaster. Accordingly, he would be in a position to support the request once it had been duly received, in accordance with the Acting Chairman's proposal.

The approach adopted by the Y.A.R. authorities in dealing with the immediate economic and financial consequences of the earthquake was broadly appropriate in the circumstances, Mr. Dallara considered, and he would give them further encouragement to collaborate with the Fund in finding solutions to the balance of payments problem. It was clear that the Yemen Arab Republic had serious underlying economic problems, the causes and consequences of which had been clearly presented and analyzed in the staff report for the 1982 Article IV consultation (SM/82/118, 6/17/82; EBM/82/102, 8/6/82). At that time, his chair had been in full agreement with the staff appraisal and had supported the staff recommendations on policies to be adopted, in particular those concerning the need for fiscal reform, control of expenditure, and the administration of taxes. He would be following with interest the authorities' progress in formulating an appropriately broadly based and comprehensive adjustment effort along the lines suggested in that earlier staff report.

Mr. Salehkhou expressed broad agreement with the thrust of the staff's appraisal and supported the proposed purchase under the emergency facility, considering the heavy economic and financial impact of the earthquake, and the country's evident qualification for a drawing related to a natural disaster. Extensive damage had been caused to the rural infrastructure in the affected area, with the disruption of the agricultural system and the loss of household grain stocks and livestock. The disaster had also produced in an urgent need for relief supplies that remained acute, despite the significant assistance already received from international organizations and bilateral donors.

The projected purchase was less than the equivalent of one month's estimated additional budget expenditure on the most urgent relief necessitated by the earthquake, and the bulk of any such outlay was bound to be reflected in higher imports, Mr. Salehkhou observed. Account should also be taken of the marked deterioration of the balance of payments position over the past few years, due partly to the reduction in economic activity in neighboring oil exporting countries and its impact on aid and remittances therefrom. A positive decision by the Executive Board was furthermore warranted by the Yemen Arab Republic's good record of cooperation with the Fund, which could be attested to by the continued technical assistance from the institution in various areas and by the authorities' intention to pursue their collaboration with the Fund to find adequate solutions to their external difficulties.

Mr. Polak supported the request for emergency assistance, which was fully in line with the Fund's policy. It had to be kept in mind that the amount that the Fund could make available under that policy was limited compared to the extent of the damage. It also had to be considered that the problem in the Yemen Arab Republic was much deeper than that resulting from the earthquake, as had been evident from the staff report for the 1982 Article IV consultation. The overall balance of payments deficit, the fiscal deficit, and the rapid decrease of foreign exchange reserves over the past few years indicated serious imbalances in the economy that he hoped would be thoroughly discussed in the forthcoming Article IV consultation. If those consultations were extended to cover measures that the member could adopt to reach agreement on a Fund program, there might be a way in which the Fund could contribute much more significantly to resolving the country's balance of payments problems.

Mr. Casey said that he warmly supported the request for an emergency drawing and, like others, looked forward to closer collaboration between the authorities and the Fund. He wondered whether any consideration had been given to increasing the amount of the emergency drawing to two tranches instead of one; even the larger amount would represent a small amount in terms of the total loss of resources, as had already been noted.

Two months had elapsed since the earthquake, Mr. Casey commented, and the staff had handled the request in an expeditious manner; nevertheless, he wondered whether the rule that the Executive Board should have three weeks' notice of any agenda items had been applied. The rule should not be followed rigidly when the Fund's resources were being used to deal with an emergency.

Mr. Morrell joined others in supporting the proposed purchase. The Yemen Arab Republic clearly had a balance of payments need that had been exacerbated by the earthquake disaster. The authorities had referred in their letter to the Fund to a program to deal with the balance of payments problems stemming from the emergency. As had already been noted, the difficulties were somewhat more fundamental, even though they had obviously been worsened by the disaster. He asked whether the authorities intended to enter into an upper credit tranche arrangement with the Fund when the full impact of the earthquake had been assessed. He also looked forward to the forthcoming Article IV consultation with the Yemen Arab Republic and hoped that the problems outlined the staff paper under discussion would be taken up at that time.

As he understood it, Mr. Morrell remarked, the rule called for the Executive Board to be given three weeks' notice of the discussion of a request for a purchase. In view of the pressing nature of the Yemen Arab Republic's problems, he wondered whether even that rule could not have been set aside.

Mr. Nair noted that the staff paper clearly showed that the request by the Yemen Arab Republic satisfied all the requirements for a drawing under the Fund's policy on emergency assistance. His chair therefore wholeheartedly supported the request.

Mr. Sangare added his support for the request by the Yemen Arab Republic and also asked Mr. Finaish to convey the best wishes of his chair to the Y.A.R. authorities.

The staff representative from the Middle Eastern Department said that consideration had been given to a larger drawing of up to two credit tranches, but the staff had been guided by the principles of Fund policies on emergency assistance discussed in the Executive Board early in 1982 (SM/82/7, 1/8/82; EBM/82/15 and EBM/82/16, 2/10/82). The principles provided that normally emergency drawings would continue to be limited to one credit tranche, although larger amounts could be made available in exceptional cases. The situation of the Yemen Arab Republic could be considered exceptional, but the authorities had not pressed the point, and the staff had thought it appropriate to limit the drawing to one credit tranche. The assistance of the Fund, and the cooperation of the member had a more important role to play than the drawing itself, as it would improve the prospects for aid from other international organizations and donors.

The possibility of a program under a stand-by arrangement with the Fund had not been excluded, the staff representative explained; it had in fact been mentioned informally during the previous Article IV consultation discussions with the Y.A.R. authorities. There were reasons why the authorities might not wish to pursue the matter at the present time. The balance of payments deficit was after all large and the quota small. Use of the Fund's resources in itself would not bridge much of the gap. Moreover, the authorities had accepted the advice of the staff over the past several years with respect to the balance of payments, and in the fiscal, central banking, and monetary fields; they were also following the recommendations that had been made by the staff in the context of Article IV consultation discussions. They were currently reviewing the results of two technical assistance studies prepared by the staff, one on the informal money market and its impact on monetary management, the other on the exchange rate and the balance of payments. As indicated in EBS/83/26, measures were being taken to raise revenue and to control expenditure. Thus, the member was collaborating closely with the Fund but without making use of the Fund's resources. Perhaps the preliminary discussions that had been held so far might proceed in the forthcoming Article IV consultation to the point of considering a program.

Some of the delay in bringing the request for an emergency drawing to the agenda of the Executive Board, the staff representative indicated, had probably been due to the intervening meetings of the Interim Committee.

Mr. Finaish thanked Executive Directors for their support. As he had stated at the beginning, the earthquake damage had been extensive and the relief and aid received limited, having come mainly from countries in the area and in particular from Saudi Arabia. Moreover, as Executive Directors had observed, the amount of the proposed drawing was very small relative to the loss of resources, one of the reasons being the small quota of the Yemen Arab Republic.

As the staff representative had said, Mr. Finaish added, the situation of the Yemen Arab Republic was exceptional; hence, larger amounts of resources of up to the equivalent of two credit tranches could have been made available to the country in accordance with Fund policies on emergency assistance. He had noted the staff representative's statement that the Y.A.R. authorities had not pressed for a larger drawing; however, the fact of the matter was that the option had not been presented to them. Had the authorities been offered that option by the staff, they would clearly have welcomed the availability of resources in an amount more in line with the losses involved. In any event, in light of the attitude of Executive Directors, he would suggest that consideration be given to making the second credit tranche available as well. A strong case had been made for a larger drawing under the relevant guidelines relating to emergency assistance. Furthermore, emergency purchases greater than 25 per cent of quota had been allowed on several occasions in the past.

The Acting Chairman commented that the staff had made a quick response to the request from the Yemen Arab Republic for emergency assistance, both in the timing of its visit and in the preparation of the staff paper. The Executive Board had been given three weeks' notice of the discussion of the request in accordance with the guidelines established by the Managing Director in the statement he had circulated on February 23, 1982. As the staff representative had indicated, the meeting of the Interim Committee had made it difficult if not impossible to shorten the three-week notice.

The practice of limiting use of the Fund's resources related to natural disasters to 25 per cent of quota had not been uniformly observed, the Acting Chairman recalled, and it would be for the Executive Board to decide whether it wished to make more than one credit tranche available in a given case or only after some broader review.

Mr. Caranicas considered that the Executive Board should take up Mr. Finaish's suggestion that the Yemen Arab Republic be allowed to draw its second credit tranche. The practice of limiting emergency drawings to one credit tranche was a matter of policy and not of applying the Articles of Agreement. The country had not had to wait to import relief supplies until it made a purchase from the Fund, but the smallness of the Y.A.R. quota and the limited experience of the Fund with its policy on emergency assistance argued in favor of building on that practice and allowing the Yemen Arab Republic to draw both its first and second credit tranches.

The Deputy Director of the Exchange and Trade Relations Department noted that when the staff paper on Fund policies with regard to emergency assistance related to natural disasters had been prepared (SM/82/7, 1/8/82), eight members had made emergency purchases, four having drawn one credit tranche and four having drawn from 42 per cent to 50 per cent of quota. The guideline under which drawings were to continue to be limited to one credit tranche had been based on experience, although it had been recognized that larger amounts could be made available exceptionally. A case could be made for exceptional treatment of the request by the Yemen Arab Republic, if the authorities wished to ask for a larger drawing.

Mr. Dallara said that he appreciated the grave difficulties and personal calamities caused by the earthquake and fully supported the proposed drawing. However, it was not clear to him that the Executive Board should attempt to change its practice relating to emergency drawings on the present occasion. If necessary, the Fund's policy in general could be reviewed. The amount of the proposed drawing did not seem particularly inappropriate. While the member was in a difficult position as a result of the natural disaster, it also faced serious underlying economic problems. Plans had been made for an early Article IV consultation, and if further Fund support of the country's adjustment effort was called for, that might be the appropriate context in which to discuss it.

Finally, Mr. Dallara remarked, while the Fund's policy of emergency assistance had been applied in a number of cases, and while the nature and and the urgency of the problem had been clear in those as in the present case, the essential purpose of the Fund was not to provide disaster relief. Fortunately, there were other organizations whose principal purpose was to deal with such problems.

Mr. Nimatallah noted that he had personally witnessed the damage caused by the earthquake, which had been severe and extensive, as Mr. Finaish had reported. Saudi Arabia had done all it could to help the Yemen Arab Republic, whose case could be considered exceptional. Since there were precedents, he would support Mr. Finaish's request to make two credit tranches available to the member.

Mr. Grosche said that he fully supported the proposal in the staff paper. If the amount of the proposed drawing were to be raised, he would have to reconsider his position.

Mr. Salehkhou observed that, in line with the remarks made by Mr. Finaish and Mr. Caranicas, he too would favor raising the authorized drawing by the Yemen Arab Republic to 50 per cent of quota, considering the small size of that quota.

Mr. Taylor commented that, for his own part, he was inclined to believe that the case under discussion was exceptional. The Y.A.R. quota was extremely small in relation to the member's prospective emergency needs, and his authorities might be willing to receive a further request favorably if it were made.

Mr. Casey said that if, when the formal request by the Y.A.R. authorities was received, it was for a drawing going into the second tranche, his chair would certainly consider such a request sympathetically.

Mr. Morrell commented that his chair would also no doubt consider such a request with understanding. The proposed drawing was clearly small in relation to the country's need, a consequence of the small quota of the member. However, whether or not the size of a member's quota was sufficient ground for changing the policy on emergency assistance was another question. He believed that a distinction should be drawn between the particular needs of the Yemen Arab Republic and the general question of changing the Fund's policy on emergency assitance.

Mr. Nair observed that the staff had brought out clearly in its appraisal that the Yemen Arab Republic's immediate need for resources far exceeded what was likely to be immediately available. Therefore, not only did the member have an obvious balance of payments need, but a case had been established for granting more than one credit tranche under the policy on emergency assistance in exceptional circumstances. If it was technically feasible, his chair would be prepared to lend its full support to the suggestion that the Yemen Arab Republic draw a larger amount.

Mr. Caranicas considered that the conditions under which four member countries had previously drawn in the second credit tranche should be taken into consideration, as a practical matter, in determining whether or not the request from the Yemen Arab Republic should also be treated as an exceptional case. From what Mr. Finaish and Mr. Nimatallah had said, the Yemen Arab Republic was in fact an exceptional case; its need was great, it had been cooperating with the Fund, and the staff would moreover shortly be conducting an Article IV consultation with the member.

The Deputy Director of the Exchange and Trade Relations Department cited the eight emergency drawings he had mentioned as having been made by the beginning of 1982. Egypt in 1962, Yugoslavia in 1963, and India in 1966 had drawn 25 per cent of quota. In 1973, Nicaragua had drawn 44 per cent of quota; in 1979, the Dominican Republic and Dominica had drawn 42 per cent and 50 per cent of quota, respectively; in 1980, St. Lucia had drawn 50 per cent of quota, while St. Vincent and the Grenadines had drawn one credit tranche. Since then, only one emergency drawing had been made: in July 1982 the People's Democratic Republic of Yemen had drawn 25 per cent of quota (EBM/82/92, 7/7/82).

Mr. Polak remarked that although the proposed drawing by the Yemen Arab Republic was related to an emergency, the need for financing was not a matter of simply importing relief supplies but, as noted in the staff paper, of reconstruction and rehabilitation that would take several years. It seemed inadvisable to make a hasty recommendation to grant a larger emergency drawing to the member without any further explanation from the staff of the reasons why the Yemen Arab Republic had not been willing to enter into a stand-by arrangement with the Fund in the past, especially as it was following most of the policies recommended by the staff. The Article IV consultations to be held in May 1983 would provide a suitable occasion for discussing more substantial assistance by the Fund on the basis of a program that the country was, in substance, more or less prepared to undertake. As a general matter of policy, assistance under the Fund's regular policies could reach high multiples of quota; such assistance would be more suitable than one or even two credit tranches of emergency assistance.

Mr. de Maulde considered that the willingness of almost all Executive Directors to consider a request from the Yemen Arab Republic for two credit tranches suggested that Mr. Finaish had won his point. He asked how long it would take for a request for the second tranche to be processed.

The Acting Chairman responded that no further time and effort on the part of the staff would be needed. As he had noted earlier, the formal request to draw one credit tranche had not yet been received, and the Executive Board was considering the request in principle only. A formal decision on the drawing--in an amount equivalent to 25 per cent or 50 per cent of quota--could be taken on a lapse-of-time basis when the authenticated request, amended if necessary, was received.

As he understood it, the Acting Chairman remarked, Mr. Dallara and Mr. Polak had in effect been suggesting that further assistance to the member ought to be based on a fuller analysis and if possible be part of a regular program, taking full account of the special circumstances due to the earthquake.

Mr. de Maulde said that his preference would be for the Executive Board to act quickly to approve an eventual request for a larger drawing.

Mr. Coene stated that because of the exceptional circumstances, he could consider favorably a request from the Yemen Arab Republic for assistance in a larger amount.

Mr. Yamashita said that Mr. Polak's position had certain practical advantages. He too felt somewhat uneasy about hastily adopting a decision that had not been put before the Executive Board. The Article IV consultation scheduled for May would also be appropriate, from the point of view of timing, for a discussion of the rehabilitation and associated financing needs resulting from the earthquake.

Mr. Finaish noted that the situation in the Yemen Arab Republic would of course be reviewed when the staff conducted the regular Article IV consultation with the member. It was the emergency situation in the country that was before the Executive Board at present. Several Executive Directors believed that the member's case was exceptional and that a drawing of 50 per cent of quota was possible under the Fund's policy on emergency assistance; as the Deputy Director of the Exchange and Trade Relations Department had just stated, half of the requests for emergency assistance handled by the Fund had been for more than 25 per cent of quota.

The situation of the Yemen Arab Republic was exceptional for at least three reasons, Mr. Finaish added. First, the damage was extremely extensive; second, the aid from other sources had been limited and had come from one or two countries at the most; third, as the staff itself had stated, the need for relief supplies remained acute. If the Executive Board agreed that the circumstances were exceptional, it could raise the size of the emergency drawing from the proposed 25 per cent to 50 per cent of quota. As he had noted, a large number of Executive Directors had supported his suggestion for such an increase. He would convey their view to his authorities, who would of course have to submit a formal request for a larger drawing, but the decision in principle could certainly be taken at the present meeting.

Mr. Sangare said that if, as the staff had indicated, the Yemen Arab Republic was an exceptional case, he would be prepared to go along with Mr. Finaish's proposal. The damage in the Yemen Arab Republic had been significant, and the member's quota was small.

Mr. Dallara asked the staff whether it had concluded that the situation of the Yemen Arab Republic was in fact exceptional compared with that of other countries that had drawn under the policy on emergency assistance related to natural disasters. It seemed to him that the issue was how to define "exceptional" in those circumstances. Another more technical question was whether or not there was any way of accelerating the timing of the Article IV consultation with the Y.A.R. authorities.

The staff representative from the Middle Eastern Department responded that there was no clear definition of exceptionality (SM/82/7, 1/8/82). Consideration had been given informally to a drawing of more than 25 per cent for the Yemen Arab Republic, but the imprecision of the guidelines had made it seem more prudent not to propose that the country should draw two credit tranches, especially as the authorities themselves had not pressed the matter. A case could have been made for a larger drawing, based on the extent of the damage caused by the earthquake, the balance of payments need, and the small size of the member's quota. It should perhaps be kept in mind that drawings from the Fund were more costly than assistance available from other international organizations. All the borrowing by the Yemen Arab Republic from the World Bank was from the International Development Association; its borrowing from other organizations was also on highly concessionary terms. The authorities were moreover aware of their obligations and had tried to keep debt service payments at a low level.

The timing of the Article IV consultation discussions, which were scheduled for early May, the staff representative noted, could be brought forward by a week or so, depending on the availability of staff. An advance team was expected to arrive in Sana'a around the end of April so that the full discussions would be held early in May.

The Acting Chairman said that there could not be very much doubt about the exceptional nature of the situation in the Yemen Arab Republic. Even if the preliminary official estimate of the damage of $1.8 billion was halved, a drawing of either 25 per cent or 50 per cent of quota would be tiny in comparison. The more immediate consequences were also considerable; for instance, the additional budgetary expenditures were provisionally estimated at $5-7 million a month.

In response to a question by Mr. Caranicas, the Acting Chairman explained that the letter from the Y.A.R. authorities requesting a drawing equivalent to 25 per cent of quota could be amended to refer to a drawing of 50 per cent of quota if the member decided, in submitting its formal authenticated request, to ask for an additional credit tranche.

Mr. Polak commented that the general question should perhaps be reconsidered, as many Executive Directors had attached importance to the limit of 25 per cent as a general rule. However, he wondered whether any thought had been given to a drawing of between 25 per cent and 50 per cent of quota, based perhaps on the size of the prospective quota of the Yemen Arab Republic as a result of the forthcoming quota increase. He inquired what the Yemen Arab Republic's quota would be once its quota increase became effective.

The Acting Chairman concluded that the sense of the meeting would be to approve a larger drawing by the Yemen Arab Republic, specifically, a drawing equivalent to two credit tranches. The Executive Board normally agreed to act by the sense of the meeting which, unless a special majority was prescribed, meant by a simple majority of votes reflected by the views expressed.

The Secretary thereupon indicated that 11 Executive Directors, having approximately 43.5 per cent of voting power, had so far indicated their willingness to consider a request by the Yemen Arab Republic for a larger drawing of 50 per cent of quota. Four Executive Directors having approximately 32.5 per cent of the voting power were not at the present stage able to consider such a request. Seven Executive Directors had not intervened in the discussion.

The proposed new maximum quota for the Yemen Arab Republic was SDR 43.2 million, the Secretary observed, compared with the present SDR 19.5 million.

The Acting Chairman suggested that the Executive Board should decide in principle that it was prepared to consider favorably a request from the Yemen Arab Republic for a drawing equivalent to 50 per cent of the present quota, if the authorities wished to make such a request. Mr. Finaish and the staff would make it clear to the Y.A.R. authorities that the Executive Board had indeed agreed in principle to make any amount up to 50 per cent of quota available under the Fund's policy on emergency assistance related to natural disasters.

Mr. Polak expressed support for the Acting Chairman's proposal on the grounds that the Y.A.R. quota was especially low; the member in fact had the fourth lowest ratio of actual to calculated quota of all members.

Mr. Finaish thanked Executive Directors for their support of his request that the Yemen Arab Republic be given the opportunity to request an additional 25 per cent of quota. That request would of course have to come from the Y.A.R. authorities in Sana'a.

The Acting Chairman observed that the Executive Board had approved in principle the request by the Yemen Arab Republic for a purchase under the Fund's policy on emergency assistance related to natural disasters in an amount equivalent to 25 per cent of quota, or, if the member wished to amend its request, in an amount equivalent to 50 per cent of quota. On receipt of the duly authenticated request from the Y.A.R. authorities, a draft decision would be circulated for approval by the Executive Board on a lapse-of-time basis. 1/

2. SUDAN - STAND-BY ARRANGEMENT

The Executive Directors considered a supplement to the staff paper on Sudan's request for a stand-by arrangement, including a description of the arrangement for reducing Sudan's debt service obligations and a proposed decision to render the stand-by arrangement effective (EBS/83/9, Sup. 4, 2/22/83).

The Acting Chairman recalled that in approving Sudan's request for a one-year stand-by arrangement for SDR 170 million at EBM/83/21 (1/28/83), the Executive Board had stipulated that the arrangement "shall become effective on the date on which the Fund finds that satisfactory arrangements have been made for the reduction of Sudan's debt service obligations for 1983 to a level consistent with Sudan's program."

Mr. Sangare noted that when the Executive Board had considered and approved the stand-by arrangement for Sudan, Directors had had an opportunity to express their views on the various elements of the stabilization program. In his concluding remarks, the Chairman had underlined the complexity of the program, which involved a financing gap that was expected to be covered by debt rescheduling. At that time, the extent of the debt relief could not be estimated. Accordingly, activation of the stand-by arrangement had been made contingent upon the satisfactory conclusion of the debt restructuring negotiations.

Following the discussions of the Paris Club of February 3 and 4, 1983, Mr. Sangare observed, significant progress had been achieved in restructuring Sudan's debt with developed countries. Furthermore, current discussions with oil exporting countries were expected to yield additional relief, and the proposals made by his Sudanese authorities to the London Club members appeared reasonable and should also result in a reduction of debt service payments. Consequently, in 1983 the overall obligations were expected to decrease from $961 million to about $227 million, representing debt relief of $734 million, an amount that approximated the original financing gap.

Consequently, Mr. Sangare urged, Executive Directors should adopt the proposed decision to make the stand-by arrangement effective forthwith.

1/ Subsequently, EBS/83/26, Supplement 1 (2/24/83) was circulated; the decision was approved on February 25, 1983 and recorded in EBM/83/40 (2/28/83).

Mr. Nimatallah noted that following the Executive Board's approval of Sudan's stabilization program, the Paris Club had met and rescheduled Sudan's debt and payments arrears on favorable terms. He was encouraged to note that the debt relief accorded to Sudan for 1983 was sufficient to cover the previously unfinanced gap in the balance of payments. His authorities had always held the view that they could go along with whatever would be helpful to Sudan in overcoming its difficulties. Therefore, he warmly supported the proposed decision on the stand-by arrangement.

Mr. Erb said that he too could support the proposed decision. However, he asked what impact the debt rescheduling agreement with the Paris Club--and any other agreements that were reached--was likely to have on the working balances of $150 million that had been set aside.

Mr. Casey said that he could support the proposed decision. The slight gap of $18 million that remained between the projected external payments gap and the likely amount of debt relief posed some risk that he was prepared to accept. He hoped that no secondary bank would take advantage of any small gap to claim, so shortly after the member had agreed with the Fund on a program, that Sudan had defaulted. The recent softening of oil prices might actually lead to some savings in Sudan's import bill; if so, the financing gap might not materialize.

Mr. de Maulde, Mr. Orleans-Lindsay, and Mr. Zhang supported the proposed decision.

Mr. Morrell added his support to the proposed decision although, like Mr. Casey, he had a slight reservation because the full amount of debt had not been rescheduled.

Mr. Finaish said that he was not in a position to confirm the information set forth in footnote 2 to Table 1 of the staff paper, in which it was stated that negotiations were under way on rescheduling debt owed to creditor countries in his constituency. Making a general point, he stressed the importance of preserving the principle of equal treatment for all creditors, particularly in maintaining confidence in the present international situation.

Mr. Grosche remarked that there seemed to be some risk left, as Mr. Casey and Mr. Morrell had indicated; but Sudan's need for positive action encouraged him to support the proposed decision.

The Director of the Middle Eastern Department remarked that the staff attached considerable importance to the availability of working balances, first, to deal with changes in the composition and possible delays in the availability of commodity aid, and second, to enable needed inputs to be imported at normal prices instead of highly inflated prices--at times well over 40 per cent of the price that would otherwise have been paid--when foreign exchange reserves were low, and short-term credit facilities had had to be utilized. In the past, the absence of working balances had led to interruptions of essential imports, such as petroleum, causing factories to shut down and resulting in an adverse impact on the budget. At any rate, central banks should normally maintain a certain level of reserves. As Mr. Erb had recalled, the staff had provided for $150 million of working balances in its original projections. But the Paris Club had decided, for the first time, to reschedule short-term obligations; since provision had initially been made for the repayment of short-term credit, its exceptional rescheduling had made available an additional $30 million for Sudan, which could serve to augment the targeted $150 million of working balances. However, once the Paris Club creditors had been repaid in the amount of $20 million, and after the oil exporting countries had been repaid an estimated $30 million that would fall due under a Paris Club type rescheduling, the working balances would be in the vicinity of $130 million. It was difficult for the staff to project the level of those working balances at any specific time during the year, because they performed a bridging function. However, if the staff's projections for the full year were correct, the balances should be positive at the end of the year, although the staff would be able to verify the situation only after determining whether Sudan had been short of imports during the year or had had to resort to expensive import financing schemes as in the past.

The availability of foreign exchange to provide for working balances of $130 million meant that there was no longer a financing gap, the Director explained. Of course, if some of the staff's estimates proved to be wrong, or if there were unforeseen developments, a financing gap could emerge, since there was little room for maneuver. However, Sudan would benefit from a fall in oil prices. Oil imports for 1983 were projected at $470 million, based on a price of $34 a barrel. Domestic selling prices for oil would not be lowered if the international oil price fell, so that in addition to savings of foreign exchange the Government would receive additional budget revenues.

As for the negotiations that were currently under way with Sudan's principal oil exporting country creditors, the Director added, the total of arrears as of December 31, 1982 and obligations due in 1983 was about $750 million. The staff had been in touch with the two major creditors, Saudi Arabia and Kuwait, which accounted for the bulk of the total, but not with the several other countries, which accounted for the balance; the Sudanese authorities had already made a proposal to one of the larger residual oil exporting creditors, and the staff had urged them to follow up with approaches to the remaining creditors.

In response to a question by the Acting Chairman about the arrangements for financing oil imports should Sudan's import bill be reduced by a fall in oil prices, the Director noted that Saudi Arabia was providing additional credit to purchase oil in 1983, as well as an additional $50 million in cash.

Mr. Nimatallah confirmed that in addition to the cash payment of $50 million, Saudi Arabia would be providing SRls 300 million, or approximately $90 million, to purchase not only oil, but fertilizers, medicine, and pesticides, all produced in Saudi Arabia.

The Director of the Middle Eastern Department, in response to a question by the Acting Chairman, said that it was not yet clear to the staff how much of the financing to be made available by Saudi Arabia would represent new money, or would merely reconfirm existing commitments.

The Acting Chairman commented that the amount of available financing was apparently somewhat greater than had been anticipated, so that the slight gap to which some Executive Directors had referred seemed to be more than fully financed.

Mr. Sangare thanked Executive Directors for the understanding that they continued to show for the economic difficulties of his Sudanese authorities, who would no doubt be encouraged to persevere with their effort to restore the economy.

The decision was:

1. The Fund takes note of the arrangements toward the reduction of Sudan's debt service obligations for 1983, described in EBS/83/9, Supplement 4 (2/22/83).

2. The stand-by arrangement for Sudan in EBS/83/9, Supplement 3 (1/31/83) shall enter into effect on February 23, 1983.

Decision No. 7333-(83/35), adopted
February 23, 1983

The Acting Chairman noted that many countries and many institutions had pulled together in the undertaking that had led to the agreement on the stand-by arrangement for Sudan; he hoped that the outcome would be satisfactory for all concerned, not least the people of Sudan.

3. UNITED KINGDOM - 1982 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1982 Article IV consultation with the United Kingdom (SM/83/18, 1/24/83). They also had before them a report on recent economic developments in the United Kingdom (SM/83/21, 2/2/83).

Mr. Anson made the following statement:

On behalf of my authorities, I should like to thank the staff for these very clear papers. As always, they give a perceptive picture of developments in the economy of the United Kingdom. My authorities can fully endorse the staff appraisal. The decisions that have still to be taken on the monetary targets and fisal measures for 1983/84 will be within the framework of the general monetary and fiscal policies described in the report.

Experience in 1982

Fall in inflation

The aim remains to reduce inflation and inflationary expectations, in order to establish a platform for sustainable growth in output and employment in the medium term. During the past year, exceptional progress has been made in reducing inflation. In January 1983, retail prices were 4.9 per cent above a year earlier. This is less than half the figure of 12 per cent recorded in January 1982, and has not been bettered at any time since the 1960s.

Inflationary expectations have not yet fallen correspondingly. This is not surprising after two decade of high inflation, often in double digits. Bt they have now begun to come down. As was to be expected, the financial markets seem to have shown more flexibility than the labor market.

Short-term and long-term interest rates remain substantially lower than a year ago, in spite of the recent market reaction to the decline in the exchange rate. The three-month interbank rate is at present around 11 1/2 per cent. The real pretax rate of interest on bank advances to blue-chip industrial borrowers is estimated to have been around 3 1/2 per cent in December; it will have risen a little since, but remains well below a year ago. After tax the real rate, for a profitable company, would be marginally negative; indeed it has at no stage been positive during the period under review.

Pay settlement rates have continued to fall, and settlements in manufacturing now average around 6 per cent. The underlying annual growth in earnings fell to around 8 1/4 per cent in December.

The real economy

Output and employment in 1982 have both been lower than expected, as in the world economy generally. With domestic demand broadly in line with previous forecasts, the main deficiency was in external demand. The latest information suggests that export shares and import penetration have not been as significant a factor as is suggested in the staff report. The U.K. share in the world market in manufactures probably increased slightly last year in volume terms, in contrast to the decline during the previous four years.

Productivity continued to improve during 1982 following the exceptional improvement during 1981. Output per man-hour in manufacturing rose by some 11 per cent from the fourth quarter of 1980 to the third quarter of 1982. This is considerably better than during previous periods of recession, and is welcome evidence that industry is responding positively to the financial and competitive pressures. Much more progress, however, needs to be made to improve the supply performance of the economy, and further measures have been taken to reduce regulations and improve incentives for industry.

Labor market

The labor market policies described on pages 11-13 of the staff report are helping to subject pay negotiations to market forces. The apparent shift of pay bargaining from national toward the company level, noted on page 12, is an indication that these policies are beginning to have an effect. The greater realism now apparent in the labor market, on the part of both employers and employees, should help to sustain the recent productivity gains during the recovery period.

In the 1982 consultation discussions, some Directors suggested that adjustment might have been obtained at a lower economic and social cost by some form of incomes policy. This issue was examined during the discussions in London and the observations of the authorities are recorded in the staff report. There is obvious advantage in promoting dialogue among the Government, industry, and trade unions on the underlying determinants of sustainable growth in the longer term, including moderation in wage and salary increases. My authorities continue to believe, however, that the introduction of a formal incomes policy would be undesirable in principle and would tend to encourage the kind of rigidities and distortions in the labor market that they have been seeking to eliminate.

Financial developments

All three of the monetary aggregates targeted in the 1982/83 budget have remained within the target ranges during the period to January 1983. The acceleration in M-1 which occurred during the summer, and which was not unexpected, seems now to have ceased, possibly reflecting the interest rate changes of 2-2 1/2 percentage points since mid-November. Sterling bank lending to the private sector was significantly lower in December and January than earlier in 1982, but the implications of this reduction for the long-term trend are not yet clear.

As in some other countries, such as the United States and Canada, interpretation of movements in the aggregates continues to be complicated by structural changes in the financial sector. The figures are interpreted flexibly, with close attention paid to all other relevant indicators, including the exchange rate.

Taking all of these indicators together, the authorities believe that monetary policy has continued to be consistent with the medium-term strategy.

The public sector borrowing requirement in the present financial year was estimated in the autumn forecast to to be £9 billion (about 3 1/4 per cent of GDP), slightly lower than the original budget forecast. The latest indications suggest that it will be within that figure.

The firmness of fiscal policy has been an important factor in helping to bring down interest rates. The fall in long-term rates was further assisted by a deliberate policy of reducing the pressure of public sector borrowing on the conventional long-term market, by tapping personal savings through indexed savings bonds. This development has also helped to revive the corporate bond market.

The effective exchange rate is now about 13 per cent below the 1982 third quarter level. While this will bring some relief to companies facing competitive pressures in home and overseas markets, they will need firmly to contain their costs, especially labor costs, in order to retain that benefit. The depreciation will also have reinforced the need for vigilance in maintaining the anti-inflationary stance of policy.

Policies and Prospects

The outlook

The official forecast published last autumn shows output rising in 1983 at a rate of around 1 1/2 per cent. This assumed that world recovery will continue to be fairly slow, with U.K.-weighted world trade growth rising at a modest rate in 1983 after a fall in 1982. No early improvement is foreseen in unemployment; indeed, the impact of weak external demand on the manufacturing sector has for the moment worsened the trend.

After the rapid fall in inflation to just under 5 per cent, little improvement can be expected in the immediate future. Given the profile of the fall last year, the pattern of monthly figures this year (compared with the corresponding month in 1982) will inevitably be somewhat bumpy. The speed of the fall in 1982 was assisted by a strong pound, weak commodity prices, lower interest rates, and more moderate pay settlements. The unexpectedly sharp fall in the exchange rate might imply a need for some upward revision in the inflation forecast, but this is partly offset by the likelihood that world oil prices will be lower than expected. The future trends in inflation and competitiveness will, as the staff points out, continue to depend crucially on further moderation in pay settlements, and on more pragmatic attitudes in the labor market.

Fiscal and monetary policy

Public expenditure plans have now been published for the financial year 1983/84. Planned expenditure in that year is within the level foreshadowed at the time of the 1982 budget, partly reflecting the better performance on inflation. Public expenditure as a proportion of GDP is projected to fall to 43.5 per cent in 1983/84, from 44 per cent in 1982/83 and 44.5 per cent in 1981/82.

The full fiscal proposals and monetary targets for 1983/84 will be announced in the budget statement next month. The Government has, however, already announced a further reduction of 1 percentage point in the national insurance surcharge (payroll tax) in that year, in order to alleviate the tax burden on industry and help to improve its competitiveness. Any further fiscal changes will need to take account of the fall in the exchange rate as well as other recent developments. As the report notes on page 10, the implied fiscal adjustment of £1 billion included in the autumn statement is a statistical concept and does not reflect a policy commitment to propose further fiscal measures of this amount.

The monetary targets will continue to reflect the policy of exerting a steady, but not excessive downward pressure on the monetary variables. Account will also need to be taken of any further structural changes foreseen in the financial markets.

External policies

The Government's policy with regard to the exchange rate remains to allow the rate to be determined by market forces. There is no exchange rate target; exchange market intervention is undertaken for the purpose of maintaining orderly market conditions and smoothing undue fluctuations in the rate.

The current account of the balance of payments is now estimated to have shown a surplus of £4.5 billion in 1982. If adjustment is made for the delay in the 1982 European Communities (EC) budget refund, this is some £1.5 billion higher than expected in the autumn forecast, about half of the difference being accounted for by oil, and much of the remainder by lower than expected non-oil imports. In the autumn forecast the surplus was estimated to deteriorate to around equilibrium in 1983, before allowing for the delayed EC refund of £0.6 billion.

As the report notes, the expenditure plans imply some real increase in the level of overseas development assistance in 1983/84. It also notes the continued high level of private flows to developing countries, including both direct foreign investment and funds recycled at U.K. banks' risk. I am glad to see that this component has been recorded in the staff report, and I hope that it will figure in Article IV consultation reports on other countries in future.

Conclusion

To sum up, the aim remains to reduce inflation as a prerequisite for sustainable recovery and growth. The authorities recognize the key importance in this connection of lower pay settlements to achieve the necessary lasting improvement in competitiveness; and they will also continue to seek to eliminate market rigidities hindering the process of recovery. They fully share the view expressed by the Interim Committee on February 11 that it is success in reducing and controlling inflation that will provide the basis, within the pursuit of counterinflationary monetary and fiscal policies, for greater real growth of activity.

Extending his remarks, Mr. Anson said that the effective exchange rate at noon that day in London had recovered slightly; it was about 12.6 per cent below the 1982 third quarter level.

Mr. Joyce said that he had no hesitation in accepting the staff's general appraisal of the strength and weaknesses of the U.K. economy, and was in broad agreement with its analysis of recent developments. On balance, the U.K. economy had performed well in 1982, largely because of the firmness of the authorities. The most noteworthy achievements had been the significant reduction in the rate of inflation and the more limited success in bringing wage costs under better control. Admittedly, part of the good inflation performance in 1982 might have been the result of transitory factors, including exceptionally favorable food prices in the third quarter. Other areas of strength for which the Government had to be commended included both the gradual reduction in the public sector deficit as a proportion of GDP, and the continuing determination of the monetary authorities to pursue policies calculated to combat inflationary expectations.

However, Mr. Joyce continued, as in many other industrial countries, the cost of those successes had been high. The performance of the real economy had been less than satisfactory. Output and employment had been lower than expected and, indeed, the outlook for 1983 was not particularly sanguine. Nonetheless, economic policymakers should continue to exercise caution. As Mr. Anson had pointed out in his statement, inflationary expectations remained high after two decades of inflation, much of it in the double-digit range. But, despite current shortfalls in real economic performance, recent developments, particularly on wages, should help to build a more solid foundation for a well-balanced recovery in the United Kingdom through the medium term. Success would require continued restraint to preserve the progress already made and a constant readiness on the part of the authorities to use whatever limited room for maneuver might exist from time to time to put in place measures encouraging greater adjustment and structural change. There seemed to be little prospect of the United Kingdom enjoying a robust recovery in the near future, and still less chance of significantly greater growth in the short term through unilateral stimulation. The U.K. Government clearly seemed to accept that position.

Nowhere had the effect of the current recession been more apparent than in the labor market, Mr. Joyce observed. By September 1982, the number of employees in manufacturing had fallen below 5.6 million, or 20 per cent below the peak in June 1979. In nonmanufacturing employment, the pattern was similar although not as severe. The adult unemployment rate stood at present at 13 per cent, with over 3 million people unemployed. As the staff had noted, one important reason for the sharp decline in employment during the current recession was that labor shedding had taken place at a much more rapid pace than in previous recessions. Indeed, given the important structural changes that had occurred during the 1970s, it was perhaps surprising that employment, particularly in manufacturing, had not declined more sharply during that period. Another important factor in slowing down the effective adjustment had been the persistence of strong wage demands. Even after the sharp downturn in employment in 1979, average real earnings had continued to increase. However, the authorities had achieved some success, particularly in the recent past, in bringing unit labor costs under better control. The measures adopted appeared to be yielding results and, as Mr. Anson had said, there was evidence of greater realism in the labor market on the part of both employers and employees.

But further actions were required if the United Kingdom was to regain its international competitiveness, Mr. Joyce considered. In four areas in particular, steps could be taken or present policies reinforced. First, manpower training and retraining programs needed to be further emphasized. In that connection, he inquired what steps were being taken to ensure that younger workers were being trained for jobs in growth sectors where they were likely to find permanent employment. He appreciated the pressures on the Government to provide immediate solutions, for instance, by job-sharing measures, but such short-term steps were palliatives and did little to encourage a lasting solution. However necessary they might seem politically in the short term, at best they were unlikely to contribute to medium-term growth and at worst they could inhibit adjustment. The authorities would also have to look to measures to encourage greater labor mobility, geographically as well as between sectors.

Second, the authorities should continue to seek reforms in existing labor legislation in order to limit abuses of power by the labor unions and restore more flexibility to the labor market, Mr. Joyce believed. The Employment Acts introduced in 1980 and 1982 appeared to have been only partially successful in that respect. Bottlenecks induced by outdated labor practices could seriously inhibit recovery and check improvements in productivity and competitiveness.

Third, additional steps needed to be taken to check unrealistic wage demands that could undercut recent productivity gains and prevent industry from attaining the levels of profitability necessary to trigger new investment, Mr. Joyce stated. He recognized that the authorities did not favor incomes policies and thought that they could distort the labor market--which they could. However, serious distortions already existed in that market, and he wondered whether the Government might not consider establishing voluntary price and wage guidelines to serve as useful benchmarks for both employers and employees. The Government had in fact already shown leadership in its attempt to restrict increases in the public sector wage bill to 3.5 per cent in 1983/84.

Fourth, Mr. Joyce considered, additional measures to spur industrial competitiveness and achieve greater profitability were essential. Manufacturing investment had performed poorly and investment in plant and machinery had declined sharply since 1979. As the staff had noted, there were indications that poor rates of return had acted as a disincentive for investment since as far back as the early 1960s. No country could build a future on that basis. He realized that the United Kingdom was not alone in registering low rates of investment, particularly in recent years, but the malaise seemed to have deeper roots in the United Kingdom and to be of less recent origin. Moreover, there were those in Europe who were not optimistic about the country's ability to maintain its relative economic position over the five years to come against its trading partners in the European Community, in terms of either inflation performance or relative output growth.

The fiscal stance of the Government appeared to be broadly appropriate, Mr. Joyce remarked, and the authorities were to be congratulated for largely realizing the objective of reducing the public sector borrowing requirement (PSBR). He agreed that any really significant relaxation in fiscal policy at the present time would be counterproductive and could reignite inflationary expectations, especially since the ratio of public expenditures to GDP had only started to decline fairly recently. But there did seem to be some room for maneuver. The calculations in the report on recent economic developments showed that the stance of fiscal policy had been becoming increasingly contractionary throughout the past three fiscal years, at a time when monetary policy had also been extremely tight. It was only in 1982/83 that there had been any evidence of some letting up of restraint, at least on a cyclically adjusted basis. If, as he was inclined to believe, there still remained further room for maneuver, it should be used, first, to support retraining and relocation policies; second, to reduce the overall level of business costs with a view to improving profitability; and third, to encourage investment. More tolerance might be shown in the expenditure columns in those three areas, and it was to those objectives that any further tax incentives should be directed in the forthcoming budget. Of course, he welcomed the announcement by Mr. Anson of a further reduction in the national insurance surcharge precisely because it did reduce the tax burden on industry.

On monetary policy, Mr. Joyce went on, the authorities were right in seeking to maintain a steady and restrictive monetary stance. As Mr. Anson had noted, the United Kingdom was not the only country experiencing difficulty in interpreting movements in the monetary aggregates. Monetary policy could be effectively implemented even in the absence of credible aggregates as long as close attention was paid to other relevant economic factors, including real interest rates and the exchange rate.

On the external front, Mr. Joyce noted, in 1982 the United Kingdom continued to have a substantial current account surplus, which was expected to disappear in 1983 despite the improvement of the competitive position resulting from the weakening of sterling during the past three months. The more recent announcement of a major decrease in the price of North Sea oil presumably suggested that further competitive reductions in international oil prices might be anticipated. It would be interesting to learn from the staff or from Mr. Anson what his authorities thought would be the likely effect of those price reductions on the value of sterling and, hence, on the export competitiveness of U.K. goods and the country's ability to contain inflation in the coming months. Did the authorities anticipate further weakness in the pound sterling, or was their view that the decline in oil prices had already been largely taken into account in the exchange market?

The sensitivity of the external sector to changes in domestic demand was, of course, a major constraint on macroeconomic policy, especially in an economy such as the United Kingdom's, Mr. Joyce observed. The Government was right to eschew the temptation of opting for an expansionary program accompanied by either import restrictions or--the course already taken by some countries--a major depreciation of its currency. Either policy would have little lasting benefit for domestic output and would tend to increase inflationary pressures. Indeed, the progress already achieved in restoring the international competitiveness of the United Kindom might be set back. He particularly welcomed Mr. Anson's assurance that the Government's policy was to continue to let the exchange rate be determined by market forces, with no official exchange rate target as such and with intervention confined to maintaining orderly market conditions and to smoothing undue fluctuations. That, in the view of his chair, was the right policy prescription.

As in most industrial countries, Mr. Joyce concluded, the attainment of stronger and sustained medium-term growth was still not quite within the reach of the United Kingdom. Moreover, any growth that could be reasonably anticipated in the immediate future was unlikely to be as strong as most Fund member governments would wish, and the fundamental structural problems remained to be solved. However, the U.K. authorities were to be congratulated for their steadfastness and determination in pursuit of those objectives.

Mr. Nimatallah said that the discussion of the U.K. economy was timely, coming as it did so soon after the Interim Committee had agreed that there was at present a basis for greater real growth in economic activity in those industrial countries that had been successful in controlling inflation. The central question for the United Kingdom--as well as for other major countries--was how to achieve a sustainable improvement in output and employment without undoing the hard-won gains in the areas of prices, wages, and productivity. There was no easy answer. But the foundation for recovery had been laid in the United Kingdom.

The authorities had adhered to their declared, medium-term strategy and some of the benefits were showing up at present, Mr. Nimatallah continued. The rate of inflation had been reduced to 5 per cent; wage settlement rates had continued to decline; and productivity had improved markedly in 1981 and 1982. Both short-term and long-term interest rates--although still at historically high levels in real terms--had fallen substantially since the end of 1981, and there had been some restoration of profit margins in industry.

But the costs of the medium-term strategy had been high, certainly higher than the authorities had originally expected, Mr. Nimatallah continued. Real growth had been modest in 1982--0.5 per cent--and performance in the main sectors had been uneven. He understood from Mr. Anson's statement that little improvement was in prospect for 1983. Unemployment stood at some 13 per cent of the labor force, and the authorities expected the unemployment rate to get worse before it got better, which it would do only very slowly. Despite the recent depreciation of sterling, the competitive position of British industry remained weak. That weakness was still the major obstacle to stronger growth in output and the creation of new jobs.

Looking ahead, the authorities might have to show a certain degree of flexibility, Mr. Nimatallah considered. The present monetary stance seemed about right. A credible framework of restraint had been established, within which interest rates had fallen, although not by as much as the authorities had hoped. The rapid decline in inflation should permit some real growth in the money stock in 1983, thereby providing a possible stimulus to activity. He welcomed the decision taken in March 1982 to move the focus of policy away from a single target aggregate, namely, sterling M-3, toward a broader and more reliable set of aggregates. In an economy with a diverse and innovative financial sector, any one aggregate was liable to distortions and could be extremely difficult to control.

There might be room to maneuver on the fiscal side, Mr. Nimatallah remarked, without jeopardizing the medium-term strategy. For the reasons outlined in the staff reports, the fiscal stance had been more restrictive than budgeted in the past two fiscal years. The PSBR had been reduced to about 3 per cent of GDP, below earlier forecasts, and was projected to fall further in 1983/84. Public expenditure had also fallen, although modestly, as a proportion of GDP. He therefore agreed with the call of the Organization for Economic Cooperation and Development (OECD) for "prudent relaxation" in the coming budget. He wondered whether Mr. Anson could comment about the possible impact on the budget of the recent cut in U.K. oil prices.

He encouraged the U.K. authorities to use whatever scope they had to assist industry to improve its competitive position, Mr. Nimatallah continued. He also hoped that they would try to strengthen the economy over the medium term by shifting the balance of public spending away from consumption and more toward capital formation.

The competitiveness of the U.K. economy depended on three factors: supply-side policies, the labor market, and the exchange rate, Mr. Nimatallah considered. He fully supported the efforts being made to ease regulations and to improve incentives for industry because they should lead to a better allocation of resources. He also welcomed the moves to make the labor market more efficient by reducing structural rigidities and restrictive labor practices. The greater realism in recent wage settlements and the continuing growth in productivity indicated that those moves were in the right direction. Although a formal incomes policy might have cost less than bringing down inflation, the present informal approach, which included cash limits for public sector pay, could serve the same purpose in a more flexible manner.

With respect to the exchange rate, Mr. Nimatallah went on, the authorities' market-oriented approach was certainly preferable to import controls or to a deliberate, large devaluation, as noted by the staff on page 7 of its report (SM/83/18). Developments in the exchange market since November 1982 showed clearly how difficult it was to predict the timing and to control the extent of a downward movement in the rate. The substantial effective depreciation of sterling should, as Mr. Anson had pointed out, benefit the competitive position of industry, provided that it did not lead to a re-emergence of inflationary pressures. It would be helpful if the staff could comment on the effects of sterling's fall on input prices in manufacturing and on how long it would take before those effects were felt in retail prices. The rise in manufacturers' costs might be offset, at least in part, by lower oil prices, and the staff's comment on that point would also be helpful. More generally, it had been suggested in the staff report that an important reason for sterling's recent fall was the likely disappearance of the current account surplus in 1983. It would therefore be useful if the staff could give revised balance of payments projections for 1983, incorporating the recent cut in U.K. oil prices.

To sum up, Mr. Nimatallah concluded, the potential for a durable economic recovery existed. The authorities were well aware of the risks of excessive caution as well as of too rapid stimulus. Their success would be important not only for the United Kingdom but for its partners in international trade and finance as well.

Mr. Lovato welcomed the discussion on the staff report for the 1982 Article IV consultation with the United Kingdom because of the widespread attention that had been paid to the authorities' stringent financial policies adopted under the medium-term strategy in 1979/80, and because of what the staff had termed their methodical approach. Those policies and the results obtained had been analyzed in an interesting way in the staff reports. Broadly speaking, he shared the judgment of the staff, although he would have preferred to see more emphasis on the costly imbalances resulting from an anti-inflationary policy applied in a dogmatic manner.

While he supported the economic objectives of the U.K. authorities, he maintained the reservations he had expressed during the previous discussion of the U.K. economy, Mr. Lovato continued, all the more so because of the results achieved by the strategy followed for the past three years. In summing up the discussion for the 1981 Article IV consultation, the Chairman had said that Directors commended the authorities for persevering with their anti-inflationary strategy, but that they had also noted with regret the heavy cost of that strategy in terms of lower output and employment, adding that the recession seemed to have bottomed out and that a modest recovery might be in prospect. Financial markets had found the strategy credible from the beginning, and the program had been carried on with determination. With a firm financial policy, the U.K. authorities had succeeded in a further substantial lowering of inflation, in terms of both actual price increases and expectations, yet the results had been disappointing with respect to growth, employment, and competitiveness. As a matter of fact, the first signs of recovery that had been mentioned in the Chairman's previous summing up had disappeared. Unemployment had increased further, and low profitability and competitiveness had continued to limit the market shares of domestic producers.

Thus, even the economic prospects for the near future were not satisfactory, Mr. Lovato observed. The staff had correctly emphasized, at the beginning of its report, the two special factors affecting economic trends in the United Kingdom at the end of the 1970s: the emergence of the United Kingdom as a major oil producer, which had strengthened the external payments position and the rate of exchange of sterling, and the response to the anti-inflationary medium-term financial strategy. The response to that strategy in the labor market had been slow, and substantial increases in public sector wages had undermined credibility in the strategy. Strong wage pressures, together with the appreciation of sterling, had contributed significantly to the worsening of the external competitiveness of U.K. non-oil industries and to the deterioration in the real rate of return on capital in those industries. He agreed that in practice the United Kingdom faced the problems of industrial countries as well as those of oil exporting countries. But, if that was the case, it would have been better for the authorities to seek the necessary adjustment by means of an informal incomes policy and a more appropriate exchange rate policy instead of further constraining enterprises by restrictive monetary policies.

He welcomed the results already achieved and the further effort that the Government intended to make in improving the legal and institutional framework in the labor market, Mr. Lovato went on, and the more pragmatic approach to monetary and exchange rate policies. He also welcomed the new and more reasonable attitude of unions that had switched their attention in pay bargaining from the maintenance of purchasing power to criteria more consistent with the health of companies. Nevertheless, British industries continued to lose market shares at home and abroad. The problem of competitiveness was clearly severe: the volume of non-oil imports was estimated to have risen by 5 per cent in 1982, and the overall volume of imports had become extremely sensitive to movements in domestic demand, which was supposed to increase faster in 1983 than in the previous year; and the surplus in the balance of payments due to oil and petroleum exports was bound to shrink or even to disappear with the reduction in oil prices. As stressed during the discussion of the world economic outlook, monetary stability was a necessary but not a sufficient condition for recovery. For the United Kingdom, it remained to be seen how and when the authorities, having had success in fighting inflation, intended to encourage a better performance with respect to profits, investment, output, and employment.

As for exchange rate policy, Mr. Lovato commented, the depreciation that had taken place over the past month represented an appropriate correction to an overvaluation of the pound sterling. He shared the view of the U.K. authorities that it was necessary to be cautious in future to avoid overshooting that could jeopardize both the credibility of the anti-inflationary objectives and the results already achieved. Such overshooting might also detract from the stimulus that productive units needed to improve productivity. To base the badly needed improvement of competitiveness only on depreciation would be detrimental to economic recovery. With respect to unit labor costs, he hoped that the new attitude of the unions would contribute to a further deceleration in the growth of wages, even in a period of recovery. Looking to the long run, it might be worthwhile to start drawing up the framework of an informal and flexible incomes policy that would take into account the relevant macroeconomic objectives. Yet so far the only improvements in productivity seemed to be due to massive layoffs. More was needed to improve the supply performance of the economy. Besides the reduction of taxes that the Government already envisaged, according to Mr. Anson's statement, enterprises should take the initiative of embarking on new processes of production and exploring new markets.

On fiscal policy, Mr. Lovato remarked, he supported the gradual reduction of the budget deficit. However, there were two reasons for concern in light of the economic objectives of the U.K. authorities: first, the reduction of public investment, and second, the failure to achieve much in the reduction in the weight of the public sector, notwithstanding the clear commitment to do so. If he was correct, he wondered why the Government's objectives had not been met or, indeed, whether it was still pursuing them. The U.K. authorities were to be complimented on their commitment to free trade.

Mr. Grosche observed that the counterinflationary monetary and fiscal policies pursued by the U.K. authorities had worked their way through the economy, producing positive results in terms of declining inflation rates and falling rates of interest. However, like the U.K. authorities, his chair was worried about the delayed appearance of the long-awaited recovery. Output in 1983 was expected to grow at only a moderate rate.

Following the rapid fall in the rate of inflation--to just under 5 per cent--little further improvement could be expected in the immediate future, owing to still prevailing wage pressures and a weaker pound sterling. The strengthening of the pound had been and would continue to be a crucial element in reducing inflation in the future.

But the massive real appreciation of the exchange rate, caused not by intervention but by a combination of restrictive financial policies and the oil boom some years previously, was no longer a blessing, Mr. Grosche commented. It was obvious that the competitiveness of U.K. goods and services had to be improved if the country was to achieve higher growth and employment. Unfortunately, while it appeared appropriate to restore competitiveness by a real depreciation, it was not clear how a nominal depreciation could be translated into a real one at reasonable costs. The authorities clearly preferred to solve the problem by bringing down domestic costs in the expectation that a fairly stable nominal exchange rate would be re-established in the market. Arguments could be found both for and against depreciation and it was difficult to assess the costs in advance. Recent oil price movements were likely to lead to a current account deficit, and there would thus no longer seem to be a conflict between depreciation and attaining balance in the current account. But, on the whole, controlling costs would provide a more lasting basis for achieving competitiveness.

Monetary policy should thus remain restrictive, Mr. Grosche continued, if achievements on the price front were to be consolidated. But the authorities should avoid using interest rate policy exclusively to stabilize the value of the pound. The optimal path, if it could be found, would be to conduct interest rate policy so that it reconciled domestic and external requirements.

While lower interest rates and lower unit costs were conditions for increasing private investment, by themselves they would not trigger the urgently needed additional investment, Mr. Grosche commented. A cautious stimulus of aggregate demand also appeared to be necessary, so that an acceleration of ongoing public investment projects was worthwhile considering as an area for some action.

The labor market situation and the low level of industrial capacity utilization led to the question of whether or not there was room for other supportive measures in the fiscal area, Mr. Grosche considered. Considerable progress had been made in curbing budget deficits so that the United Kingdom was, to his knowledge, the only major industrial country showing a surplus in the cyclically adjusted public budget. In addition, the public sector borrowing requirement was well below planned levels. Although the room for maneuver was obviously limited, some measures could therefore perhaps be envisaged. On the revenue side, the authorities could consider a further reduction in the employers' national insurance surcharge beyond that already planned for 1983/84. Such a cut in the payroll tax would help to improve the profit situation without jeopardizing further external developments. A general income tax cut would not, in his view, be advisable; it could cause balance of payments problems because increased private demand for consumer goods tended to pull in foreign goods owing to the present lack of competitiveness of domestically produced goods.

He shared the authorities' concern about the continuing decline of capital expenditure, Mr. Grosche remarked. The repeated undershooting of budgeted targets, by local authorities especially, was apparently caused by the penalties imposed by the Central Government if targeted levels were exceeded. It might be worthwhile reviewing those penalty schemes.

With respect to labor market policy, Mr. Grosche continued, the U.K. Government had made welcome efforts to overcome the deeply ingrained rigidities that made the implementation of restrictive policies so costly in social terms. The 3.5 per cent increase in public sector wages envisaged for 1983/84 seemed appropriate in the global situation, and he hoped that contracts in the private sector would follow the same guidelines. The progress achieved under the Employment Acts of 1980 and 1982, reforming the legal framework of industrial relations, was highly welcome although the United Kingdom still had a long way to go. While he understood Mr. Anson's reluctance to consider a formal incomes policy--the U.K. view was similar to that of Germany in that respect--additional ways could perhaps be found to promote a dialogue among the Government, industry, and trade unions on the underlying economic factors.

He invited the staff or Mr. Anson to give further thought to the question of whether or not the National Economic Development Council could play a more active role in identifying bottlenecks in the supply of labor, without implying direct government intervention. In that respect, the training schemes for the unemployed were constructive steps. Perhaps attention might be given to improving vocational training to increase the availability of skilled labor, especially in engineering.

To conclude, Mr. Grosche remarked, he had once again been struck by the protracted and difficult process of adjusting to a changing economic environment in democratic societies, where fundamental attitudes of both labor and industry changed only slowly and at high social cost.

Mr. Hirao remarked that since 1979/80 the U.K. authorities had been implementing a strongly anti-inflationary medium-term financial strategy. Under that strategy, nominal monetary and fiscal targets had been established with a view to exerting persistent downward pressure on the rate of growth of total nominal expenditure. Through those efforts, the public sector borrowing requirement had been brought down from nearly 6 per cent of GDP in 1980/81 to just over 3 per cent in 1982/83. Monetary policy also seemed to have been reasonably stringent. In addition, the authorities had implemented measures aimed at regaining flexibility in labor markets.

The result of those efforts, Mr. Hirao continued, was that the rate of inflation had fallen dramatically from a peak of 21 per cent to a range of 6-7 per cent, as measured by the 12-month rate of increase in retail prices. The latest information provided by Mr. Anson on the further fall in the inflation rate in the past month to 4.9 per cent was all the more encouraging. There had been an associated steep decline in short-term and long-term interest rates. The authorities were to be highly commended for their firmness and for those impressive achievements. The stage had been set for the sustained recovery of economic activity, and domestic demand in real terms had resumed its growth at a rate of about 2.5 per cent a year.

In spite of those various favorable developments, Mr. Hirao went on, it was noted in the staff report that the rise in unemployment was unlikely to be checked soon because low levels of profitability and competitiveness continued to limit the share of demand satisfied by domestic producers. He had taken note of Mr. Anson's view that falling export shares and rising import penetration had not been as significant a factor in the lower than expected rate of growth as was suggested by the staff. It would be interesting to have the staff comment on that point. In any event, although the increase in productivity had been significant, it had apparently to be attributed mainly to a large-scale shedding of labor. To achieve a sustained improvement in productivity, it would be important to increase investment in plant and equipment, something that would have to be preceded by the restoration of corporate profits to adequate levels. In that respect, he tended to agree with the staff that further moderation in the growth of earnings remained a crucial element in the improvement of competitiveness as well as in the control of inflation. He had been encouraged to learn from Mr. Anson's statement that pay settlement rates in manufacturing had recently fallen to about 6 per cent.

Referring to more specific aspects of policy, Mr. Hirao observed, first, that he considered it appropriate for the authorities to include M-1 and a broad measure of private sector liquidity as target variables along with sterling M-3. Under present circumstances, exchange rate considerations played an important role, especially in relation to the competitiveness of U.K. industries and inflation. He tended to agree with the staff that "as long as exchange rate adjustments are consistent with a continued favorable performance on inflation, monetary policy can be regarded as broadly on track," and that "with monetary policy balanced in this way, there is little scope for changing its stance in either direction." He would be grateful, however, if the staff could elaborate a little further on its preference for the discrepancy between the indicative limit and the official forecast of the rise in M-1 to stand "as an indicator of concern."

On fiscal policy, the authorities should be highly commended for bringing down the PSBR in 1981/82 beyond the budgeted amount, Mr. Hirao considered. It was an exceptionally impressive achievement, one that was in sharp contrast to the fiscal situation of other industrial countries, including Japan, where fiscal deficits continued to overshoot original estimates despite strenuous efforts on the part of the authorities. He also welcomed the continued fiscal austerity demonstrated in the public sector spending plan for 1983/84. The staff had noted the present PSBR projection of 2.75 per cent of GDP as being within the appropriate range for 1983; he tended to agree with that assessment. In that context, it had been of interest to him to note the authorities' argument that "companies would regard a lowering or abolition of the NIS [National Insurance Surcharge] as permanent, while interest rate movements might be perceived as transitory." He would be inclined to think that a lowering of business taxes might not necessarily be perceived as permanent if a sizable fiscal deficit remained. Thus, reducing the fiscal deficit would probably help to restore business confidence in economic management. However, in the United Kingdom, the PSBR had perhaps been steadily reduced to a sufficient extent to restore business confidence.

As for labor market policies, Mr. Hirao commented, various steps had already been taken to ensure the realistic pricing of labor as a means of re-establishing the competitiveness of U.K. industry. It was particularly encouraging to learn that "there are indications of a new realism in labor markets...that should help sustain productivity growth during the recovery." Like the staff, he regarded the efforts to contain the increase in the public sector wage bill to 3.5 per cent in 1983/84 as an important signal for wage negotiations in other sectors.

In the area of exchange rate policy, Mr. Hirao considered that the authorities' "middle" view was pragmatic and appropriate. While sterling depreciation had not been ruled out, it had been carefully limited, and the authorities were basically committed to financial policies designed to put steady downward pressure on price inflation. He endorsed that type of approach as the most effective way--although it would take time--to restore the competitiveness of U.K. industry.

Mr. Polak noted that the present was the third Article IV consultation with the United Kingdom during the tenure of the present authorities and so constituted in a sense the third review of their medium-term financial strategy. That strategy had, over time, attracted increasing support, for three main reasons.

First, Mr. Polak remarked, while there had been grounds for considerable doubt about the strategy's effectiveness in earlier years, it had become clear that the intermediate aims had now been attained. Inflation had been reduced sharply, interest rates were down, profitability had improved, and productivity had increased sharply. There had been a noticeable reduction in the public sector borrowing requirement, and, in a sense the crowning and most difficult achievement, public expenditure as a percentage of GDP, which had initially continued to climb persistently, had turned around and was on a downward trend, despite obviously cyclical elements retarding adjustment. Lower interest rates had helped in that connection. It might also have been particularly helpful that the U.K. Government had taken the position that oil revenues should not be considered as automatically available for increasing expenditure. That decision was certainly wiser than those taken by some other countries.

Second, Mr. Polak added, some of the more extreme policy components had in fact been quietly abandoned. For example, the unrealistically low target growth rates for sterling M-3, which had been consistently exceeded during the first three years, had been raised from the level for the current year of 5-9 per cent to 8-12 per cent for 1982/83, an important increase. Moreover, a number of other measures had been introduced as yardsticks of the tightness of monetary policy. In addition, although the nonpolicy relating to the exchange rate that had led to extreme overshooting had been given up, it had not been replaced by an exchange rate policy. As Mr. Anson had pointed out, the Government would continue to allow the rate to be determined by market forces; there was no exchange rate target. At the same time, however, the exchange rate, and for that matter also the interest rate, had been accepted as supplementary indicators of financial conditions. It was clear that the insertion of the exchange rate into monetary policy had influenced the exchange rate itself through the impact that the rate had in setting monetary policy.

Third, while the same success had not been achieved in the real sphere, other countries following other policies had not been noticeably more successful, Mr. Polak remarked. Domestic demand had been rising for the past 18 months at a rate of about 2.5 per cent, to a large extent apparently through a reduction in the savings ratio, but aggregate demand and output, excluding oil, were still virtually flat, mainly because of the negative growth in the foreign balance, it was said. In many places in the staff report, the behavior of the foreign balance was attributed to a lack of competitiveness, which had led to a reduction in the export shares of the United Kingdom and to increased import penetration. But Mr. Anson had more or less dismissed that as a significant factor. It would be helpful to know how important the lack of competitiveness had been, or rather how important it would be following the decline of the value of sterling in recent months. It was inevitable that the U.K. economy would be less competitive than it had been in international trade in non-oil commodities, given the importance to the balance of payments of oil, but it should be sufficiently competitive to permit a satisfactory balance on current account and an adequate level of output.

As Mr. Anson had somewhat laconically put it, Mr. Polak noted, output and employment in 1982 had both been lower than expected, as in the world economy generally. In an attempt to appraise the entire policy package, the most welcome sign that he saw was the successful start on the reduction of government expenditure. The staff had indicated that care should be taken not to go too far in lowering the PSBR, so that interest rates would not fall much further. In a sense, an equally important success of the reduction in government expenditure was that room was beginning to be made for what had been an important element in the original strategy, namely, the lowering of the cost of business.

He welcomed the steps taken to reduce social security premiums, Mr. Polak added; he would welcome further steps as part of the forthcoming budget. The matter went beyond the question of international competitiveness, where the exchange rate would unavoidably be a major element. It was also a question of the distribution of internal incomes and the elimination of the depressing influence on private industry arising from the exercise of too large a government role, financed by continued increases in taxes and social charges. The results of the past year, and the confident forecasts for the coming year, seemed to him to constitute a real breakthrough. Together with the substantial correction in the real exchange rate that had been taking place, they might combine to give some hope that in the next review of U.K. strategy, positive results in the real sphere might be visible. To that end, wage moderation would be extremely important, and monetary policy could not be made too easy for fear of upsetting the exchange rate. All in all, however, the various pieces of U.K. policy seemed to be falling into place.

Mr. Finaish observed that he had been struck by the statement in the first paragraph of the staff appraisal that returns to the U.K. authorities' medium-term financial strategy had begun to come through, much as might have been expected. He felt sure that the staff did not mean to imply that the very large drop in output and the increase in unemployment since 1979 had been the inevitable consequences of a strategy of inflation control, or that the magnitude of those adverse effects was in line with what had been anticipated at the outset. Evidently, the actual costs of controlling inflation had turned out to be far greater than had originally been expected, and the country had been going through its deepest recession since the 1930s. Since mid-1975, non-oil output had fallen by more than 7 per cent, with output in the manufacturing sector alone falling by about 15 per cent, and unemployment more than doubling to well over 13 per cent. Whether those economic and social costs could have been mitigated under an alternative and broader mix of policies was an interesting question.

It was noted a little further on in the staff appraisal, Mr. Finaish continued, that "much of the deceleration of price inflation can be traced to monetary restraint." Since a major factor behind the deceleration of inflation had been the appreciation of sterling, the assumption was presumably that the latter had been mainly the result of monetary restraint. Yet a sizable proportion of sterling's appreciation since 1978 could be attributed to the increased strength of the United Kingdom's external position as a direct result of its emergence as a major oil producer; to that extent the cause of the deceleration of inflation would be different. Perhaps the staff could comment briefly on the relative roles of the two factors.

While the appreciation of sterling had helped to lower inflation, it had considerably weakened the competitive position of industry, Mr. Finaish stated. Even after the significant depreciation of sterling in 1981 and in late 1982, its real effective rate remained about 40 per cent above the 1978 level. The large deterioration of competitiveness had resulted in a substantial loss of the shares of U.K. industries in export markets, as well as at home through greater import penetration. The poor competitive position of domestic industry had also meant that the upturn in aggregate domestic demand since mid-1981 had had very little effect on domestic output because most of the increase was reflected in higher imports. Thus, a further improvement of competitiveness was of critical importance for the recovery of output and the reduction in unemployment, as well as for the strength of the external position over the medium term.

The question was how to improve competitiveness adequately, Mr. Finaish added. The focus of the authorities' strategy had been to lower unit labor costs by means of a further moderation in the increase in earnings, supplemented by faster growth in productivity. That objective was of considerable importance and should continue to be pursued with vigor. However, to the extent that reductions in unit labor costs were matched by similar reductions in the costs of the major trading partners of the United Kingdom, as had been the case so far, the improvement in competitiveness would have to come from further depreciation of the nominal exchange rate.

Two questions of policy interest arose in that respect on which the staff comments would be helpful, Mr. Finaish noted. First, could a significant improvement in the competitiveness of the U.K. industry be expected in 1983 on the basis of the projected further reduction in the rate of increase of unit labor costs, assuming no further depreciation of the nominal exchange rate? If not, the question was whether or not the authorities could afford to adopt a more flexible stance with respect to the nominal exchange rate, if indeed a margin existed for a further significant--although not abrupt--depreciation of that rate that would not result in an offsetting larger increase in wage costs through the rekindling of inflation. In considering that question, it would be useful to bear in mind that depreciation of the nominal exchange rate for sterling since early 1981 had translated itself rather well into a depreciation of the real exchange rate.

A significant factor behind the appreciable reduction in the rate of increase of unit labor costs over the past two years had been a rather remarkable increase in productivity, Mr. Finaish remarked. However, since that improvement had been mainly due to large-scale shedding of labor, another question on which the staff might care to comment was whether the recent rate of productivity growth could be sustainable in the medium term. A similar but broader question was whether wage restraint resulting from the present very high level of unemployment would be sustained when unemployment began to return to socially acceptable levels. Similarly, it would be interesting to know whether the staff had made any estimate of the so-called natural rate of unemployment in the United Kingdom.

An important condition for continued productivity growth and for a sustained improvement in the growth rate was a healthy rate of investment, Mr. Finaish declared. The sharp drop in investment levels in the United Kingdom in recent years should therefore be a cause for serious concern. Total investment in real terms was at present appreciably below the 1979 level, and the ratio of gross capital formation to GDP in the United Kingdom was by far the lowest among major industrial countries, as well as being well below the OECD average. The decline in investment had been particularly pronounced in the manufacturing sector and in the public sector. Public sector fixed investment had been falling consistently since 1977 and was currently more than 40 per cent lower in real terms than it had been a decade earlier. Over the same period, the shares of total capital expenditure and fixed capital formation in total public expenditure had fallen from about 17 per cent and 13 per cent to about 6 per cent and 3.5 per cent, respectively. Clearly, those trends did not auger well for the United Kingdom's future growth prospects and productivity growth.

While North Sea oil had necessitated some difficult structural adjustments in the industrial sector, Mr. Finaish remarked, it had also provided new resources that could be used for investment in modernizing and expanding industrial capacity. However, it appeared from the aforesaid trends that the additional resources had little, if any, positive impact on the level of investment. With the exchange rate for sterling moving relatively freely to absorb the full impact of the oil surplus, the benefits had so far mainly gone into consumption through lower import costs.

It was worth noting that the large decline in public sector investment in recent years had occurred while total public expenditure had risen relative to GDP, contrary to the objective of the medium-term financial strategy, Mr. Finaish observed. Thus, the improvement in the fiscal position, as reflected in the reduction in the PSBR relative to GDP, had been achieved not through the curtailment of government spending, as had been sought, but through an increase in government receipts. Moreover, the brunt of the Government's efforts to contain public expenditures had been borne by fixed investments. Thus, whereas the objective of reducing PSBR in terms of GDP had been largely achieved, the accomplishment masked some developments that had been less satisfactory.

In that connection, perhaps the staff or Mr. Anson could explain the apparent slight discrepancy between the figure for total government expenditure as a proportion of GDP mentioned on page 30 of the report on recent economic developments and that given in Mr. Anson's statement, Mr. Finaish suggested. Whereas the staff had shown an increase from an average of 41 per cent in the years prior to the medium-term financial strategy to 46 per cent in 1981/82, Mr. Anson had mentioned a figure for the past year of 44.5 per cent.

Finally, Mr. Finaish noted, the volume of U.K. oil exports was estimated to have increased by 5 per cent in the first three quarters of 1982, and domestic oil production was estimated to have risen from 1.8 million barrels a day to 2 million barrels a day during the whole year. That was a notable outcome in a year when oil production and export volume had fallen significantly in almost all major oil exporting countries, and he had missed a discussion in the staff reports of the official policy on oil production and export levels. U.K. exports of oil were projected in the staff report to increase in volume terms by a further 3 per cent in 1983, and it would be helpful to know what the underlying assumptions were.

Mr. Kafka remarked that he was happy to be able to agree with the staff's assessment of developments in the United Kingdom as a success story. The authorities should be congratulated not only for having brought down inflation and for having persisted in their cause, despite difficulties, but more generally for having achieved a difficult task of re-establishing credibility for government policies. The achievement had been largely due to a felicitous combination of monetary and fiscal policy with the halving of the PSBR since 1980/81 and the maintenance of downard pressure on sterling M-3 and M-1, which had expanded at the same rate in 1982 as in 1981; larger increases were foreseen for 1983, but that might not be unreasonable in view of changes in the preferences of the holders of liquidity. He tended to agree more with the U.K. authorities than the staff and would find a separate limit for M-1 to be rather reasonable.

It was encouraging that the staff found room in the anti-inflationary monetary policy for a sustained recovery of economic activity, Mr. Kafka went on. The price that the United Kingdom had paid so far, in the context of worldwide recession, for bringing down inflation, re-establishing credibility, and laying the groundwork for sustained growth, had been high in terms of unemployment. Despite changes in industrial relations laws and the stop that had been put to the excessive protection of workers on strike under the social security system, given public attitudes in the United Kingdom, the price paid had been no higher than necessary to achieve the degree of success that had been achieved. Undoubtedly, an infinitely higher price would be paid in a country that was poorer and less well endowed with social welfare institutions than the United Kingdom. The two basic questions posed by the persistent resistance to noninflationary nominal wage settlements were, first, when would wage pressures become more compatible with reasonable improvement in profitability, and second, how long would it take once recovery had begun to unlearn the lesson that had been learned with respect to wage pressures and the consequent unemployment?

Recent developments in petroleum markets and their reflection in exchange markets would give some independent stimulus to exports and import substitution, Mr. Kafka commented, and he hoped that it would not be offset by excessively liberal monetary and wage policies. It should be easier for the United Kingdom than for others to resist pressures for protectionism, and the authorities should resist pressures for scaling down official development assistance, a point made by the staff with which he agreed. Meanwhile, recognition was due to the United Kingdom for the private outflows that were taking place to developing countries.

Mr. de Maulde remarked that, with due respect for tradition, the staff had as usual noted in its report that recovery in the United Kingdom was just a short time away and that the full benefit of past efforts would soon be reaped. In that respect, the statement in the staff appraisal that the rapid fall in the inflation rate should provide room for the sustained recovery of economic activity, even though the rise in unemployment was unlikely to be checked soon, was a proper match, in the observance of tradition, for the view expressed in the previous staff report that a measure of patience was required to permit growth to resume on a sustainable basis.

The fact was, Mr. de Maulde continued, that even if considerable success had been achieved in terms of inflation, the real economy was not in the best of condition. GDP was currently 3 per cent lower in real terms than it had been four years before. Industrial production was 8 per cent lower, and unemployment more than 5 per cent higher. Projections for the near future, both by the OECD and the IMF, tended to show that in the coming 18 months the United Kingdom was expected to perform only marginally better on balance than other European countries, meaning that unemployment in particular would continue to increase.

He wondered what had gone amiss with the real sector of the U.K. economy, Mr. de Maulde stated. Its performance was all the more puzzling because, at the time of the second oil shock, the United Kingdom had almost alone escaped the balance of payments constraint that had forced other countries into retrenchment and austerity. And during the past four years, the United Kingdom had also been, as Mr. Polak had stated, a model for the rest of the world in implementing the kinds of policies recommended by the Fund. By any standard, the efforts undertaken to conduct a tight fiscal policy, to adhere to monetary restraint, and to fight against so-called structural rigidities in the economy had been admirable. Indeed, it might be asked whether the United Kingdom was applying the Fund's recommendations or the Fund was basing its advice on U.K. policies.

With the benefit of hindsight, Mr. de Maulde went on, three main factors, unforeseen at the outset, seemed to have impaired the Government's medium-term strategy. Those factors were the deterioration of the external environment, the stickiness of wages, and the overvaluation of the currency.

Concerning the external environment, Mr. de Maulde mentioned that it could be said that the United Kingdom had shared in the general deterioration, but that it had also contributed to making it worse. True, the decline in the competitiveness of U.K. industries had made room for the exports of other countries in various U.K. markets, including the domestic one, but it might also be argued that a stronger U.K. economy would have led to a higher volume of trade, even in the absence of the artificial competitive advantage that other countries had enjoyed during the past few years.

On wages, the most urgent economic task in 1979, Mr. de Maulde recalled, besides reducing the rate of inflation, had been to achieve a decrease of some 4-5 percentage points in real wages in order, first, to restore the external competitiveness of U.K. manufacturers and, second, to raise profits to a level that would allow investment to resume. The simplest and most effective way to lower real wages might have been through administrative action to freeze salaries for a short time, meanwhile letting prices deflate. For various reasons, the U.K. Government had preferred a more complicated solution. Four years later, the desired results in terms of real wages had not been fully achieved; they only seemed to be closer at hand, and the cost had been the current rate of unemployment. Wage earners in the United Kingdom had demonstrated the most stubborn resistance to monetary and fiscal policies, to the point of calling for the embodiment of their attitude in economic theory.

The third factor affecting the U.K. economy had been the overvaluation of the pound, Mr. de Maulde considered. Month after month, exports of manufactures had deteriorated, and more and more imports would replace the domestic products. Dollars continued to flow from North Sea oil, maintaining bullish exchange rates and imposing upon the authorities the need to conduct an even tighter monetary policy to counteract the domestic effect of those inflows of capital. Was it possible that other ways and means could have been found to protect the rest of the economy? He looked forward to hearing all the imaginative answers possible to that central and fascinating question from others around the table.

To sum up, Mr. de Maulde said, he did not completely agree with Mr. Polak's assessment. He had a feeling that if the real economy had had a spell of bad luck, the United Kingdom had brought it upon itself to some extent.

As for the present, Mr. de Maulde stated, the question that came to mind, to use the fashionable jargon, was how much of a margin for maneuver the United Kingdom had. He shared the staff view that the margin was probably narrow in terms of wages and profit levels. Some more direct action, as had been suggested by some Executive Directors, might be warranted. The position in two other fields was different. First, the difference between the rate of inflation in the United Kingdom and its partner countries had been eliminated, for all practical purposes. Second, a sound public finance position had been painfully rebuilt; given the slack in the real economy, the financial position might even be too sound. As other Directors had mentioned, the many structural difficulties from which U.K. industries had suffered in the past appeared to make the United Kingdom a prime subject for the recommendation that the authorities should implement far-reaching programs aimed at modernizing and reinforcing productive capacity, including most importantly, programs of education and training. That was indeed the recommendation of the European Communities. Such action seemed far preferable to any attempt to boost consumer spending, in the fragile price and wage situation prevailing in the United Kingdom.

He fully supported the recommendation in the staff appraisal that the U.K. authorities refrain from scaling down official development assistance, Mr. de Maulde remarked. The United Kingdom had been a leader in that field in the past. To retreat from its position at the present time would send a wrong signal to other countries. He therefore welcomed greatly Mr. Anson's helpful comments on the subject.

It would be useful to know from Mr. Anson or the staff, Mr. de Maulde said, what modifications might have to be made in the economic projections to take account of various hypotheses of lower oil prices than had initially been assumed in the staff reports.

To conclude, Mr. de Maulde commented that the well-being of the U.K. economy was important to the well-being of the world economy, and especially for the region to which France also belonged.

The Executive Directors agreed to resume 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/83/34 (2/22/83) and EBM/83/35 (2/23/83).

4. ST. VINCENT AND THE GRENADINES - 1982 ARTICLE IV CONSULTATION - POSTPONEMENT

Notwithstanding the period of three months specified in Procedure II of the document entitled "Surveillance over Exchange Rate Policies" attached to Decision No. 5392-(77/63), adopted April 29, 1977, the Executive Board agrees to postpone its consideration of the 1982 Article IV consultation with St. Vincent and the Grenadines until not later than March 18, 1983. (EBD/83/41, 2/16/83)

Decision No. 7334-(83/35), adopted
February 22, 1983

5. TOGO - 1982 ARTICLE IV CONSULTATION - POSTPONEMENT

Notwithstanding the period of three months specified in Procedure II of the document entitled "Surveillance over Exchange Rate Policies" attached to Decision No. 5392-(77/63), adopted April 29, 1977, the Executive Board agrees to postpone its consideration of the 1982 Article IV consultation with Togo until not later than March 4, 1983. (EBD/83/45, 2/18/83)

Decision No. 7335-(83/35), adopted
February 22, 1983

6. <u>EXECUTIVE BOARD TRAVEL</u>

Travel by an Executive Director as set forth in EBAP/83/52 (2/18/83) is approved.

APPROVED: July 25, 1983

LEO VAN HOUTVEN
Secretary