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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 83/36

3:00 p.m, February 23, 1983

W. B. Dale, Acting Chairman

Executive Directors	Alternate Executive Directors
A. Alfidja	
J. Anson	C. Taylor
	L. E. J. Coene, Temporary
	A. Le Lorier
A. Donoso	
R. D. Erb	C. Dallara
M. Finaish	S. R. Abiad, Temporary
	Jaafar A.
T. Hirao	T. Yamashita
R. K. Joyce	
	H. Arias, Temporary
	G. Grosche
G. Lovato	
R. N. Malhotra	A. S. Jayawardena
	J. E. Suraisry
J. J. Polak	
	K. G. Morrell
G. Salehkhou	
	E. I. M. Mtei
M. A. Senior	J. L. Feito
J. Tvedt	
Zhang Z.	Wang E.

L. Van Houtven, Secretary
J. C. Corr, Assistant

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Also Present

African Department: J. B. Zulu, Director; O. B. Makalou, Deputy Director; Buu Hoan, Y. Fassassi, R. Franco, C. A. François, S. M. Nsouli. A. Tahari. Asian Department: 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: G. Belanger, S. Kanesa-Thasan, M. O. Tyler. Fiscal Affairs Department: V. Tanzi, Director; J. C. Tavares, O. Pettersen. Legal Department: Ph. Lachman, S. A. Silard. Research Department: A. D. Crocket, Deputy Director; J. M. Boughton. Western Hemisphere Department: J. Ferrán. Personal Assistant to the Managing Director: N. Carter. Advisors to Executive Directors: A. A. Agah, C. J. Batliwalla, J. Delgadillo, P. Kohnert, H.-S. Lee, P. D. Péroz. Assistants to Executive Directors: L. Barbone, R. Bernardo, J. Bulloch, M. Camara, T. A. Connors, M. K. Diallo, G. Ercel, A. Halevi, M. Hull, W. Moerke, V. K. S. Nair, Y. Okubo, J. K. Orleans-Lindsay, J. G. Pedersen, G. W. K. Pickering, M. Z. M. Qureshi, J. Reddy, C. A. Salinas, H. Suzuki, J. C. Williams, A. Yasseri.

1. UNITED KINGDOM - 1982 ARTICLE IV CONSULTATION

The Executive Directors continued from the previous meeting (EBM/83/35, 2/23/83) their discussion of 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. Tvedt observed that it was clear from SM/83/18 that, although wages and price inflation had been reduced substantially and interest rates had fallen sharply, growth and unemployment had remained the most disappointing areas of performance in the United Kingdom. In that respect, it was puzzling that the staff appeared to be recommending in their appraisal the continuation of the economic policies recently pursued by the U.K. Government. There was reason to reappraise the current policy stance. In light of the recent World Economic Outlook discussions in the Executive Board and at the Interim Committee meeting, his authorities believed that a shift toward more expansionary policy was called for, particularly in the United Kingdom and some other leading industrial countries in which inflation had already been brought under reasonable control and the external position was fairly satisfactory.

A policy shift would benefit not only the United Kingdom but also its main trading parters, Mr. Tvedt continued. The inflation rate had been brought down from 19 per cent in 1980 to 6.7 per cent in 1983. At the same time, the underlying rate of inflation, as measured by unit labor costs, had decelerated from 22 per cent to an estimated figure of under 3 per cent. Furthermore, the U.K. economy was characterized by a low level of capacity utilization as well as high and increasing unemployment. Against that background, the risk of renewed inflationary pressure from a more expansionary economic policy should be limited; it was a risk worth taking.

The present balance of payments position gave additional room for maneuver to support an increased level of activity and to encourage the expected recovery, Mr. Tvedt considered. As his authorities had noted during the Interim Committee meeting, countries such as the United Kingdom should, at least in the short run, be prepared to tolerate fiscal deficits of a cyclical nature. Taking into account the present stage of the economic cycle and the savings behavior of other sectors of the economy, it would be preferable if the U.K. authorities followed such a policy and if they did not attempt to offset the cyclical increase in the borrowing requirement by discretionary fiscal policy measures. Such a policy recommendation was of particular importance for the United Kingdom, where the fiscal deficit as a percentage of private savings was far below the average for major industrial countries in 1982 and 1983. It seemed that the cyclically adjusted fiscal budget would be in surplus in both years. The authorities ought also to be aware of the danger of overkill from strict adherence to a financial strategy requiring a reduction of public sector borrowing as a percentage of GDP over the medium term.

The recent easing of monetary policy and the fall in nominal interest rates were welcome, Mr. Tvedt remarked. However, real interest rates remained too high and a further easing of monetary policy appeared appropriate. He noted Mr. Anson's statement that the Government's exchange rate policy continued to allow the rate to be determined by market forces. Exchange rate policies should aim at avoiding drastic fluctuations in the exchange rate in the short run, especially against other European currencies. The question arose whether the Government's emphasis on the exchange rate as a yardstick of the tightness of monetary policy implied a more far-reaching change in the United Kingdom's exchange rate arrangements, for example, in its relation with the European Monetary System. He invited Mr. Anson to comment. As the staff had suggested, the authorities should resist pressures to increase protection and to scale down official development assistance.

The U.K. authorities were facing a complex and difficult situation, Mr. Tvedt stated, and there was no panacea. However, the staff had been too cautious in its appraisal of economic policy in the United Kingdom. He was particularly concerned about the strong emphasis on restrictive monetary and demand management measures against the background of very high and rising unemployment. In view of the recent slowdown of inflation, he hoped that the authorities would reorder their priorities in favor of employment and growth. In that regard, he supported Mr. Joyce and others who had called for increased manpower training and a more comprehensive incomes policy approach.

Mr. Zhang noted that, in the report for the 1981 Article IV consultation with the United Kingdom (SM/82/19), the staff had counseled "a measure of patience to permit growth to resume on a sustainable basis." The expectation had been that bringing down inflation would itself promote such growth. However, the present report gave the impression that the United Kingdom's problems had remained essentially unchanged. As in other major industrial countries, the rate of inflation had come down substantially; however, real output had stagnated and unemployment had risen from 11.5 per cent to 13 per cent during 1982, the highest rate in any major industrial country. Nevertheless, there had been no improvement in competitiveness and the country's share of export markets had continued to decline. As pointed out in the staff report, British costs at the prevailing exchange rate were so high that profitable opportunities in activities subject to foreign competition were severely restricted; consequently, increases in aggregate demand had not "elicited a commensurate domestic supply response" but had, inevitably, generated larger increases in imports. In the 1981 report, the staff had referred explicitly to the need for a further reduction in the real exchange rate; there was no mention in the present report that such reduction had not taken place in 1982.

On that point and some others, Mr. Zhang remarked, the staff had tended to concentrate on developments over the previous two years rather than developments since the previous Executive Board discussion of the United Kingdom (EBM/82/20, 2/19/82). For example, the statement on page 7

of SM/83/18 that "the effective exchange rate has in fact depreciated at an average annual rate of just over 7 per cent in the last two years" was hardly a fair description of the fact that the exchange rate had remained at about the same level since mid-1981. Similarly, it was somewhat mistaken to say that between the last quarter of 1980 and the third quarter of 1982, unit labor costs in manufacturing had risen at an annual rate of less than 4 per cent and that the competitiveness of the United Kingdom had correspondingly improved, when, in fact, as shown in Chart 1, there had been no significant improvement in competitiveness since the fall of 1981, although the rise in unit labor costs had continued to moderate. Figures in Table 2 indicated that the rise in 1982 had been little more than half of the increase between 1980 and 1981.

On the basis of the experience of the past few years, Mr. Zhang added, the continuance of the broad thrust of present policy strategies would not lead to a spontaneous recovery and sustained growth as originally envisaged. In view of the economic situation, the authorities might have been expected to be in a position to take some steps to reflate the economy. However, control of inflation would remain the preeminent objective of economic policy in the United Kingdom, with the continuing hope that such a policy would, by itself, establish a basis for sustained growth in the unspecified medium term. For that purpose, the authorities "remain committed to financial policies, including monetary and exchange rate policies, designed to put steady downward pressure on price inflation."

Although the staff recognized that an improvement in competitiveness was required before sustained growth could be realized, Mr. Zhang observed, it stressed that monetary policy should ensure that exchange rate adjustments were consistent with continued favorable performance on inflation. It appeared to be suggesting that any depreciation that might cause a faster rise in prices was to be avoided. That advice was supported by a passage asserting that "a low rate of price inflation is still necessary to secure the wage restraint without which depreciation of the currency would...have little effect on competitiveness." The staff added that moderation in the growth of earnings was "crucial" for the improvement of competitiveness.

The staff also put forward the suggestion that it was reasonable to wait for the time when labor began to price itself back into employment, Mr. Zhang noted. That advice appeared to ignore the fact that firms had to see profitable opportunities before they would hire additional workers. Labor pricing itself back into employment also required a lower growth in earnings; in addition, in sectors exposed to foreign competition, those in employment should accept wage reductions in order to price others into employment. Such an outcome was likely to be exceedingly difficult, if not impossible, to achieve through wage negotiations. Although the rate of wage increase had been substantially reduced, there was no indication that the competitive position was improving. Therefore, bringing costs back into line mainly through wage restraint, while avoiding a nominal depreciation for fear of rekindling an inflationary spiral, would take a long time, and it would certainly incur the very high social and economic costs of high unemployment.

The process might eventually prove longer and costlier than the existing policies could maintain, Mr. Zhang considered. Taking everything into account, an immediate and lasting improvement in the competitive position might be secured by a moderate nominal depreciation. At the present high rate of unemployment, it appeared unlikely that a moderate further depreciation would produce a marked acceleration of wage and salary inflation. He invited the staff to comment on that point. If a developing country had been facing a similar situation, would the staff not have recommended depreciation as the most effective cure?

Mr. Senior stated that he agreed with the staff appraisal. The U.K. authorities should be commended for the design and implementation of a consistent anti-inflationary program that established a platform for substantial growth in the medium term. The program took due account of the fact that, in an economy as open as that of the United Kingdom, interest rates, monetary targets, and exchange rates could not be independently controlled. The authorities had only one area of freedom, and they had chosen to control monetary growth without aiming simultaneously at particular interest rate or exchange rate objectives. Such consistency in the design of policy, as well as the determination shown by the authorities, had contributed greatly to the credibility of government policies. As a result, the program had begun to attain a degree of success in attaining its major objective--the control and abatement of the inflationary process that arose at the beginning of 1980.

Certain costs and imbalances remained despite the success achieved against inflation, Mr. Senior continued. As the staff pointed out, the high cost and the self-destructiveness of a program of monetary restraint in the face of slow-reacting labor costs were widely appreciated. The rigidity of the labor market in response to lower rates of inflation had imposed a severe burden on the non-oil sector, particularly on those branches producing durable goods.

The development of the oil sector had been accompanied by a real appreciation of the pound, Mr. Senior commented, dictated by the need to draw resources from sectors producing non-oil tradable goods. In other words, the development of the oil sector had been achieved at the cost of the other sectors producing export and import goods. The rigidity of real labor costs had added to the oil-induced squeeze on the non-oil sector of the economy, accelerating the tendency for the share of manufacturing industry to decline. In addition, given the relative capital intensity of the oil sector, structural as well as frictional unemployment had increased as a result of the redistribution of resources that had taken place in the economy.

The comments made by Mr. Anson concerning the recognition by the authorities of the key importance of lower pay settlements to achieve lasting improvement in competitiveness and the need to concentrate on the elimination of market rigidities in the period ahead were welcome, Mr. Senior stated. Counterinflationary and financial policies should be accompanied by an increase in the flexibility of the major markets of the economy if they were to succeed in the end.

Mr. Donoso commented that it was apparent that economists still did not know how to achieve stabilization without incurring some costs, even in the most well-defined program. The main reason usually appeared to be the rigidity of wages, which tended to keep increasing at a rate inconsistent with other prices in the economy, after demand restraint measures had been applied. In such circumstances, reductions in the rate of increase of money would lead to some reduction in real monetary aggregates, increases in the rate of interest, and imbalances in the relationship between the prices of final goods, labor costs, and unemployment. Reduced profitability in industries producing for domestic and, especially, for export markets was a normal characteristic of a period of adjustment to lower rates of inflation. Such developments had occurred in the United Kingdom; to some degree, they would continue during 1983.

There would be a continuing need to improve competitiveness, Mr. Donoso suggested, if an increase in demand was to induce growth without rekindling inflation or causing a deterioration in the current account balance. Although there had been dramatic improvements in the control of inflation, monetary restraint would have to be maintained until a reduction in real wages made it possible to resume growth without fueling price increases. The firm financial policy that had been in existence in recent years had to be maintained; it should be focused on trying to slow down the rate of increase in wages.

The adjustment could have been faster, perhaps, if the authorities had constrained further the increase in wages of public employees during the previous two years, Mr. Donoso continued. Was it appropriate to aim at limiting the increase in the public sector wage bill to 3.5 per cent in 1983/84 when inflation was expected to be 6 per cent and when increases in competitiveness were so important? He asked the staff to comment on the relationship between wages in the public sector and wages in the private sector during the previous two years, and on the expected rate of increase in wages in the economy as a whole in 1983 if public sector wages were to increase in line with the authorities' target.

The United Kingdom had had to face the costs of stabilization, Mr. Donoso remarked, and those costs would continue for some time. However, the basis for final success existed, since the credibility of the Government's policies was already established. The stabilization effort was an important "investment" for achieving faster growth rates. It was a fundamental element in the comprehensive strategy that included improvements in the working of the labor market by curtailing the monopoly power of unions, the exposure to competition of industries controlled by government monopolies, and the reduction in the size of the public sector, including the sale of public corporations to the private sector. He hoped that the ambitious program would be entirely successful.

However, the elements that could prove equally valuable to the improvement of efficiency by eliminating restrictions to international trade were absent, Mr. Donoso added. Such restrictions had been increasing in the previous decade. As a member of the European Community, the United Kingdom was a participant in a system that had certain negative features

with respect to trade promotion. A few changes affecting the U.K. import system were listed in SM/83/21. The fact that some of them aimed at reducing restrictions obscured the point that many aspects of the system of decisions, directives, and regulations of the European Community tended to inhibit trade. The setting of quotas, ceilings, or negotiating restraints with supplier countries in a continuously evolving structure not only reduced the flow of traded goods directly but generated uncertainty with regard to the conditions that would prevail in the near and medium term.

Higher import tariffs, a common tool for protecting domestic production, set a limit to the degree of relative inefficiency that a country was willing to maintain, Mr. Donoso argued. Changes in the quantity of permitted imports, attempts to stabilize import penetration ratios, or the use of discretionary measures in general, inhibited export-oriented investment in many countries. It became impossible to measure the degree of protection such measures afforded, as the effective protection depended significantly on the degree of uncertainty created. The staff had failed to emphasize the need to reverse such policies affecting trade to the same extent as it had emphasized other structural changes aimed at accelerating growth. Finally, he commended the U.K. authorities for their determination to implement the courageous program under discussion, and he welcomed the positive developments reported by the staff.

Mr. Erb said that, like other Directors, he was impressed with the progress that had been made in the United Kingdom both with regard to inflation and, perhaps even more so, with regard to the improvement in productivity that was taking place. He agreed with other speakers that it was disappointing that employment had deteriorated and that it had yet to improve. He joined those Directors who had expressed optimism about the future prospects for economic growth and employment growth within the United Kingdom. While Mr. Joyce had correctly pointed to the need to ensure greater labor mobility and appropriate training, more emphasis should be placed on the need for increased investment, as Mr. Hirao had suggested; in that connection, the need to improve profits and, therefore, to continue wage restraint would be important for the future recovery of employment within the United Kingdom. Wage restraint would also help to improve U.K. competitiveness, which, in combination with world economic recovery, would certainly strengthen the prospects for U.K. economic growth.

Perhaps the staff or Mr. Anson could comment on the basis for their different judgments regarding the competitive position of the United Kingdom, Mr. Erb suggested. He emphasized the relevance of the point raised by Mr. Polak on whether the difference in judgments could be accounted for by the notion of a longer-term full employment current account.

There also appeared to be differences of emphasis between the staff and Mr. Anson on the appropriateness of a fiscal stimulus, Mr. Erb continued, which had also been expressed among Executive Directors. Specifically, the view had been put forward that increased government expenditures and a

larger fiscal deficit should be used to stimulate the economy. Both the staff and Mr. Anson suggested that a lower fiscal deficit would lead to lower real interest rates, thereby depressing the value of sterling. Both sets of views could be said to favor growth within the United Kingdom through the impact of lower interest rates on domestic investment and through the improvement in the competitive position. At the same time, both the staff and Mr. Anson warned that the possibility of a counter-productive feedback through increased inflation had to be taken into account. However, the staff reported that "the U.K. representatives thought it not impossible that a lower [public sector borrowing requirement] with given monetary policy would, by lowering interest rates and the value of sterling, provide more stimulus than a tax cut." Was there a real difference of views between the staff and the authorities on the subject? The question was fundamental because a number of authorities were having to decide what was a stimulative fiscal policy--a lower deficit or a higher deficit?

The judgment of the markets also had to be considered, Mr. Erb went on. On page 64 of SM/83/21, the staff stated that the strength of sterling during 1982 could be attributed to the more rapid progress of the United Kingdom in reducing wage and price inflation and the apparent conviction of market participants that firm monetary and fiscal policies would continue to be applied. The implication was that a tighter fiscal policy, at least as perceived by the market, would result in a strengthening of sterling, not a weakening. It appeared that progress had not been made to the extent expected in reducing the size of the government sector relative to GDP. Of course, cyclical factors could distort such a ratio, when there was a decline in GDP, but it was worth considering whether the U.K. experience offered lessons regarding the impact of the level of fiscal expenditures on economic growth. Did it result in "crowding out"? Besides the problem of crowding out as a result of the fiscal deficit, there was the issue of the total impact of government expenditures on the economy. More progress in that regard might be conducive to future economic growth. Mr. Finaish had raised an interesting question when he had referred to the composition of expenditures, suggesting that, even if the public expenditure/GDP ratio was held constant, a stronger impact on economic growth would be felt if a larger proportion of expenditures was directed toward investment.

Commenting on monetary policy, Mr. Erb noted that the staff had pointed out that the monetary authorities were taking account of exchange rate developments and interest rates as well as developments in the monetary aggregates. He invited the staff or Mr. Anson to comment more precisely on the question of how the exchange rate was taken into account in monetary policy. He understood that the authorities focused on an index of the real effective exchange rate; it was worth considering whether, from a monetary policy point of view, it might not be more appropriate to focus on a particular exchange rate, perhaps the dollar rate; a decision to do so would depend partly on the monetary policy of the country on the other side of the chosen exchange rate. On page 49 of SM/83/21, the staff had suggested that the dollar exchange rate was probably the most important, given the importance of currency substitution that appeared to be taking place.

On page 8 of SM/83/18, Mr. Erb observed, the staff stated that the decline in sterling in late 1982 suggested that financial pressures might have eased about then, at least in relation to some of the other major currencies. However, later in the paper, the staff emphasized current account developments and oil price developments in its discussion of the exchange rate. Again, the question arose of how to take account of the impact of the exchange rate on monetary policy when there could be several factors simultaneously influencing the rate. That was an important issue for a number of countries, particularly the major currency countries, and it deserved further empirical analysis by the staff.

The difference between the staff and the U.K. authorities on the relative importance of M-1 or M-3 as a money supply target might be resolved by approaching the question empirically, Mr. Erb suggested. Which aggregate had a closer relationship to the ultimate targets that the monetary authorities were attempting to influence? If it turned out that M-1 was a better indicator over time for policymaking purposes, perhaps it should be used rather than M-3. He could agree with the judgment that the rapid growth in M-1 that had taken place was acceptable because it was a result of the decline in inflation and in interest rates, if empirical evidence existed that changes in the demand for M-1 could be expected to produce such significant responses.

With regard to the oil question, Mr. Erb remarked, perhaps Mr. Anson could say whether, in retrospect, the authorities regretted that more foreign exchange reserves had not been accumulated when the sudden increase in oil exports had produced a substantial shift in the current account, particularly in light of the expectation that the strength of the current account arising from the United Kingdom's oil exports would begin to reverse itself within a short period. A more immediate question would be whether there was a case for a more active reserve policy to offset sudden shifts in oil flows if the oil markets were faced with greater price fluctuations, producing larger short-run fluctuations in oil revenues.

Mr. Jaafar commented that the growth rate of the U.K. economy over the previous few years had been disappointing. Real GDP had declined by 2 per cent in 1980, and by another 2 per cent in 1981, before showing a small increase of 1/2 of 1 per cent in 1982. In 1982, according to the staff report, total domestic demand had increased at an annual rate of 2.5 per cent, but its impact on real GDP had been minimal because much of the increased demand had leaked out to higher levels of imports as domestic industry became less competitive over the years. The situation had been brought about by the prevalence of high wage costs and interest rates, as well as the strength of the pound, resulting in a decline in the profitability of industries and in new investments. The cost competitiveness of U.K. industries would have to be improved as a matter of priority if the economy was to achieve better growth performance.

A number of developments had already taken place that tended to suggest some improvement in the competitive position of U.K. industries, Mr. Jaafar noted. First, the rate of wage increases had moderated considerably from over 20 per cent in 1980 to about 6 per cent in 1982. The

decline was primarily due to the slack that had developed in the labor market, providing an incentive for labor unions to lower their wage demands. However, wage increases would have to moderate further and to remain low for some time, perhaps several years, if industrial profitability was to be restored to a level that would provide incentives for new investments and for higher capacity utilization.

In addition, interest rates had fallen substantially in 1982, reflecting a combination of factors, Mr. Jaafar observed, including the decline in the inflation rate in the United Kingdom, the decline in U.S. interest rates, and confidence in the ability of the U.K. authorities to maintain the public sector borrowing requirement within prudent limits. The decline in interest rates would no doubt have a positive impact on investment and growth in the U.K. economy. Real interest rates remained highly positive; he presumed that there was little that the U.K. authorities could do to lower them further. Much would depend on what happened to U.S. interest rates.

Another factor that had recently contributed to some improvement in the competitiveness of U.K. industries was the exchange rate, Mr. Jaafar considered. Mr. Anson had pointed out that the effective exchange rate was currently about 12 per cent below the level of the third quarter of 1982. In the final two months of 1982, the pound's effective exchange rate had depreciated sharply, following a 9 per cent depreciation in 1981.

The developments that he had mentioned all pointed in the direction of improved incentives for investment and growth, Mr. Jaafar continued. It would, presumably, take time before those changes had an impact on the real economy. He invited the staff to comment on whether the prospects for higher profitability arising from the deceleration of inflation, wages, and interest rates, and the decline in the effective exchange rate, would be adequate to restore reasonable rates of growth in the U.K. economy. Did the staff believe that additional measures would be necessary or desirable at present?

The U.K. authorities should be complimented for their prudent demand management policy that had resulted in the sharp decline in the rate of inflation, Mr. Jaafar suggested. In particular, he drew attention to the authorities' success in keeping monetary growth in the target range of 8 per cent to 12 per cent, and their ability to control, indeed to reduce, the public sector borrowing requirement as a percentage of GDP. However, he believed that some relaxation of policy might be appropriate, in view of the improved price performance, the capacity underutilization, and the higher rate of unemployment--over 12 per cent of the labor force.

Commenting on trade practices, Mr. Jaafar noted that the staff mentioned on page 89 of SM/83/21, that it was the policy of the U.K. authorities to impose trade restrictions only when sudden surges of imports threatened to cause an unacceptable degree of disruption to a domestic industry. He invited the staff to provide further details on the application of that policy: first, the number of instances in which restrictions

had been introduced in 1982; second, the industries that enjoyed protection; and third, the country of origin of the imports on which restrictions had been imposed.

The U.K. authorities should be commended for their official development assistance to developing countries, Mr. Jaafar added. He urged that such assistance be continued and strengthened in the future, particularly in areas like education and training that had benefited many developing countries in the past.

Mr. Coene said that developments in 1981 and 1982 had underscored doubts that the medium-term economic strategy pursued by the U.K. authorities would, over the next few years, bring about balanced noninflationary growth leading to high levels of employment while maintaining external balance. Despite the remarkable success of the medium-term financial strategy in bringing down inflation, for which the authorities were to be commended, and despite the question of whether a different approach could have been as effective in moderating price increases, it was unlikely that the present financial strategy and the further gains against inflation that it might bring about would lead to a recovery of economy growth and the gradual absorption of the very high unemployment. The focus on the struggle with inflation, and the policies pursued in that struggle, together with the development of North Sea oil, ran counter to the structural adjustments needed in the non-oil sectors.

The extremely low level of profitability in the non-oil sector, and the low level of capacity utilization there, practically excluded the possibility of a recovery of investment, Mr. Coene continued, while import penetration had set limits to the possible expansion of domestic demand. For those reasons, he shared Mr. de Maulde's difficulty in understanding the staff's conclusion on page 15 of SM/83/18 that the steep drop in inflation should provide both room for, and some of the stimulus to, a sustained recovery of economic activity. The staff illustrated the point by referring to the growth of domestic demand in 1982, but it had to acknowledge that the external balance constraint placed a limit on such expansion.

The staff viewed moderation in the growth of earnings as a crucial element in the improvement of competitiveness, Mr. Coene observed. Substantial improvement had been achieved in bringing more realism into the process of wage determination, as Mr. Anson had indicated. Wage restraint was useful in cases in which the gap in external competitiveness was relatively small. However, it had to be asked whether such an approach could produce a sufficiently rapid improvement in profitability when the gap in cost competitiveness was much larger. The staff reported that present cost competitiveness was about 40 per cent below the 1978 level; although that figure was not particularly relevant, the order of magnitude was a good indicator of the size of the gap that had to be closed to maintain external balance at a higher level of activity. The staff argued on page 4 of SM/83/18 that there had been some improvement in the profit situation in the non-oil sector, but the situation did not appear clear-cut.

The trends of cost and price indicators, as shown on page 65 of SM/83/21, indicated little improvement in export competitiveness in 1981 and 1982. Even if it was admitted that profits had improved, they remained insufficient, as illustrated by the low level of investment in plant and equipment. He invited the staff to comment further on those points.

During the Executive Board discussion of the previous Article IV consultation with the United Kingdom, Mr. Coene recalled, his chair and others had argued that the overall economic situation of the United Kingdom could not be improved much further solely by relying on wage restraint and restrictive financial policies. Indeed, it was doubtful whether wage restraint alone would achieve a real effective depreciation of the exchange rate. While he acknowledged that wage restraint should be continued through formal and informal incomes policies, he believed that it could be supported by a more flexible approach toward the exchange rate. Nominal depreciation, applied in a prudent and well-managed way, would have brought about lower interest rates and greater improvement in the profitability of enterprises, and it would have resulted in a larger expansion of economic activity without reversing the downward trend of inflation, while reducing oil revenues in part. Such a policy would have been much easier to apply in 1982 because, at that time, it could have been done in a managed way, when declining commodity prices would have permitted some depreciation without slowing the downward trend of inflation. However, the policy would be much more difficult to apply in 1983, especially if it should be imposed by external circumstances related to oil price trends.

In addition, rising commodity prices during the first stage of the expected international recovery would be amplified by a depreciation of sterling, Mr. Coene commented, leading to new price increases. Any improvement in competitiveness would, therefore, be much harder to achieve. Although their position on the exchange rate was straightforward, it was not clear how the U.K. authorities would react to exchange rate movements. If commodity prices rose and oil prices fell, would the authorities brace themselves and "lean into the wind," in order to avoid any depreciation of sterling by restricting monetary policy and raising interest rates? Or would they "bend with the wind," by allowing the exchange rate to depreciate gradually, as they had apparently done during the fourth quarter of 1982? In the latter case, how was the exchange rate to be viewed as an indicator of the relative stringency of monetary policy? Although the authorities' policy of allowing market forces to determine the exchange rate of sterling remained in place, during the fourth quarter of 1982 they had undertaken market intervention on a scale that was rather large to be termed a mere smoothing operation. Could the staff and Mr. Anson comment further on the issue?

In view of the limited progress so far achieved in wage moderation despite strict fiscal policies, Mr. Coene remarked, his chair believed that the size of the competitiveness gap required a more flexible use of the exchange rate to improve substantially the real economy in the United Kingdom. In the absence of such measures, it might be much more difficult to withstand protectionist pressures. On other issues, he generally shared the staff's assessment.

Mr. Malhotra observed that the aim of the U.K. authorities continued to be to reduce inflation and inflationary expectations in order to establish a basis for sustainable growth in output and employment in the medium term. After three years of following the Medium-Term Financial Strategy, which emphasized a firm commitment to the progressive deceleration of money supply growth, results were beginning to be seen. Inflation had been greatly reduced, and labor productivity had increased. However, the cost in terms of unemployment had been high, and the economy's long-term recovery prospects remained uncertain. Other speakers had noted that output had been negative or stagnant, that unemployment had risen to historically high levels, that the competitiveness of British industry remained low, and that investment growth had also remained either negative or stagnant. The question, therefore, arose whether the present set of policies, which had undoubtedly brought about a welcome and substantial reduction in inflation, had had a healthy impact on the level of wage settlements; whether they improved the profitability of industry; and whether they were sufficient to bring about a healthy recovery of the British economy.

At the moment, the prospects did not appear encouraging, Mr. Malhotra continued. The staff considered the prospects for 1983 very modest. Real GDP was estimated to grow by 1 per cent and unemployment was expected to worsen further from the current level of 13 per cent. The revival of the U.K. economy was vital not only to the United Kingdom itself; it could also contribute to the revival of the world economy.

It was time to consider whether persistence in present policies was the appropriate response to the present situation, Mr. Malhotra suggested, or whether changes in the policy mix were needed to bring about recovery. The anti-inflationary policies pursued by the U.K. Government with great determination had evoked a large measure of credibility. The authorities had successfully restrained the growth of budgetary expenditures and the public sector borrowing requirement. However, when adjusted for cyclical factors, the budget deficit, in conjunction with the restrictive monetary policy, might have had a contractionary impact. In the view of his authorities there was a good case for considering whether changes could not be made in both fiscal and monetary policies to promote output and investment.

There had been impressive increases in productivity, as measured by output per unit of labor, Mr. Malhotra noted. He invited Mr. Anson to say whether it was possible to make an assessment, if only qualitatively, of the weight that should be attached to the various elements that had contributed to that improvement. For example, how much weight should be attached to capacity closures, to reductions in the labor force, or to restraint in wage settlements? Such an analysis would be helpful in gauging whether the productivity gains were the result of real improvements in efficiency or of factors that might reverse themselves once the recovery was under way and employment began to pick up. Another interesting issue was the degree of the trade-off in the economy as a whole between labor productivity and the extra outlays to maintain unemployed labor, either

through budgetary policy or under other arrangements. Were the overall gains in productivity in industry counterbalanced by the extra cost to the economy of providing support to unemployed labor?

Some months previously, The Economist had carried an interesting article about a survey of the unemployed in the United Kingdom, Mr. Malhotra recalled. The article indicated that many of those who had been unemployed for several months did not expect their job applications to be considered for some time. The Economist had commented that, despite the phenomenon, not many people were angry with the Government, and it had wondered whether the unemployment support policies were responsible and whether, in the long-term interests of the economy, policymakers should not be concerned about the situation.

The problem of the declining competitiveness of British industry was not new, Mr. Malhotra remarked. The authorities had focused primarily on restraining wages, with some measure of success, but other aspects of the question deserved equal attention, for example, how to promote the introduction and efficient use of new technologies and how to deal with older declining industries. The problem was not amenable to rapid solution, but the question had to be asked whether competitiveness and productivity could be improved in the long run merely by changes in prices, such as the price of labor, foreign exchange, or capital.

Commenting on the oil sector, Mr. Malhotra noted that Mr. Finaish and Mr. Erb had already raised, in slightly different form, the question of how the gains from the United Kingdom's large oil exports should be used. Should the revenues accruing to the Government be used to modernize the economy? How should the authorities react to the prospect of oil prices declining?

The United Kingdom's record in overseas assistance had been remarkable, Mr. Malhotra considered. The quality of U.K. assistance had been high; he welcomed the planned increase of 8 per cent in 1983/84. Considering the generally bleak outlook for external assistance, such an increase was welcome, and he hoped that the authorities would improve it further. While the increase in bilateral development assistance was welcome, his authorities strongly urged the U.K. authorities to maintain, and if possible, to increase their strong commitment to multilateral assistance. His authorities also appreciated the positive role played by the U.K. Government with regard to the International Development Association (IDA). He noted that the invisible account continued to have a strong positive effect on the British balance of payments.

Mr. Morrell stated that his chair was in broad agreement with the staff assessment; there was little room for significant stimulation of the U.K. economy in the short term. The authorities should be commended for the considerable achievements that they had made in the battle against inflation. Their success had been attained by the adoption of and adherence to a range of policies in the context of their medium-term financial strategy. The very fact of adopting and maintaining a medium-term plan

was worthy of commendation. Such an approach should make a positive contribution to business confidence and to the reduction of inflationary expectations. It was not unusual to hear complaints in other countries of a lack of coherent long-term planning by governments and of the difficulty thus created for local business planning.

The accepted doctrine maintained that a reduction in inflation was a necessary condition for a return to sustainable growth, Mr. Morrell continued. The example of the United Kingdom clearly demonstrated that while it might be a necessary condition, it was not a sufficient condition. As other speakers had noted, British exports would have to become more competitive in world markets if reasonable export-led growth was to be achieved. He agreed with those Directors who had suggested that there was a need for significant investment in the modernization of U.K. productive capacity.

The level of unemployment in the United Kingdom was a matter of serious concern, Mr. Morrell considered. The causes were many, not the least being an apparent unwillingness on the part of the unions to adjust their demands to levels that were consistent with the health of the economy. The rise of 60 per cent in relative unit labor cost between 1978 and 1981, an increase unprecedented among the major industrial countries, was indicative of the difficulties. At present, there were some glimmers of hope, such as the public sector wages policies and the measures that the Government had taken to reduce rigidity in the labor market. The authorities should be commended for the course they were pursuing in attempting to deal with a problem that was universal. No country could claim to have fully adequate answers to labor market problems. The overvalued exchange rate appeared to be one cause of unemployment and the underutilization of capacity. However, the recent reduction in the value of sterling would certainly make a positive contribution to the growth of British exports. He commended the authorities' commitment to a freely floating exchange rate system.

Mr. Mtei remarked that it was clear that reductions in inflationary expectations had been the main objective of recent U.K. economic policy and that the authorities had made progress toward that goal. The rate of increase in the retail price index had fallen from about 21 per cent in the first half of 1980 and 12 per cent at the end of 1981 to about 6.5 per cent in the fourth quarter of 1982. It was expected to fall further, to 5 per cent, in 1983. The success in the fight against inflation had led to a sharp decline in nominal interest rates, although real rates remained high. However, there was no doubt that the achievement had had its costs, notably the very high level of unemployment.

A number of factors seemed to account for the authorities' success in bringing inflation under control, Mr. Mtei continued. There had been strict adherence to the Government's anti-inflationary medium-term financial strategy. Public sector borrowing had been curtailed, and the rate of monetary expansion had been curbed. Unit labor costs were falling,

reflecting in part labor-shedding by industry and the authorities' determination to see wages determined more by market conditions than by negotiations with the trade unions. The prices of imported commodities and other imports had also been falling. However, the relative contribution of each of those factors was difficult to determine from the papers before Directors. The decline in commodity prices was particularly important to the countries in his constituency. The staff had not indicated the impact on prices in the United Kingdom of increases in commodity prices as economic activity picked up around the world. He hoped that it was not being assumed that commodity prices would remain low in the years ahead.

As several other Directors had pointed out, Mr. Mtei added, the performance of other economic indicators had not been particularly good. GDP growth in 1982 had been estimated at only 0.5 per cent; it might reach 1.4 per cent in 1983. Growth in domestic demand had not succeeded in stimulating supply. Instead, it had spilled over to the external sector, leading to a worsening of the foreign balance. Such a development reflected, inter alia, the loss of competitiveness of the economy vis-à-vis other major industrial countries. The continued decline in the United Kingdom's share of export markets, despite an increase in volume of oil exports, strengthened that conclusion, a point on which the staff report was very clear.

However, it was not clear how much relative labor costs had contributed to the loss of competitiveness, Mr. Mtei commented. According to the staff, those costs remained high. The exchange rate had also played a role; Table 3 of SM/83/18 indicated that the pound had appreciated by 7.1 per cent in 1979 and by 10.1 per cent in 1980. The subsequent depreciations of 0.8 per cent in 1981 and 5.1 per cent in 1982 appeared too small to reverse the adverse impact on export performance of the earlier appreciation. There might, therefore, be a case for the authorities to have a closer look at their exchange rate policies. Mr. Anson had stated that his authorities' policy was to allow the rate to be determined by market forces. He hoped that what Mr. Anson had referred to as "market intervention for purposes of maintaining orderly market conditions and smoothing undue fluctuations in the rate" was not itself having adverse consequences. After all, the timing and the extent of any intervention was a matter of judgment.

Another point deserving attention, but not covered in the staff analysis, was the extent of structural rigidities in the U.K. economy at present, Mr. Mtei went on. It could be an important reason for the loss of competitiveness, both internally and externally. He invited the staff or Mr. Anson to comment on that point. As many Directors had noted, the sources of the problem had to be correctly diagnosed and appropriate policies applied, since the United Kingdom's economic difficulties had repercussions on others, particularly on the countries in his constituency.

The labor market remained extremely weak, Mr. Mtei noted, with unemployment at 13 per cent. Training and retraining measures, especially to deal with youth unemployment, were urgently needed to avoid the social

unrest and other problems that could result from such high levels of unemployment. High unemployment in conjunction with the loss of competitiveness in industry was likely to encourage protectionist measures. Finally, official development assistance had risen from 0.35 per cent of GDP in 1980 to 0.4 per cent in 1981. He commended the U.K. authorities for their increased aid effort, but more could be done, particularly since the 1981 performance was considerably below that of 1978 and 1979, when ODA had reached 0.47 per cent and 0.42 per cent of GDP, respectively. He urged the authorities to try to reach the ODA target of 0.7 per cent of GDP as soon as possible.

The staff representative from the European Department noted that one Director had questioned the staff's statement to the effect that the returns to the medium-term financial strategy had "begun to come through much as one might have expected." The strategy had involved a gradual deceleration of the rate of monetary expansion, on the assumption that the more rapid the decline in inflation, the more room would remain for recovery in real output or, at least initially, in real demand. It was clear that increased room for the expansion of real demand had emerged, in line with the staff's expectations. As many Directors had noted, the increase in demand had spilled out abroad and, therefore, it had not been translated into increased real domestic activity to the extent that the staff and the authorities might have desired. Unfortunately, that weakness continued to exist.

The reason the increase in demand had spilled out abroad instead of expanding domestic output was a lack of competitiveness, the staff representative continued. It was sometimes argued that the existence of high unemployment indicated a deficiency in demand and that, therefore, a more stimulatory policy might be appropriate. The short response to such an argument was that a more vigorous expansion in real demand would be of little benefit to the domestic economy if it continued to spill out abroad. Competitiveness had to be restored first; that was the central issue.

Taking up the questions on monetary policy, the staff representative stated that, on the basis of revised data, the final sentence of the first paragraph on page 15 of SM/83/18 should read: "The wider aggregate (sterling M-3) expanded by 10.5 per cent in 1982, compared with 13 per cent the year before. The growth of the narrow aggregate (M-1) increased from 11 per cent to 11.5 per cent, reflecting the pressure from interest rates." The revised data did not require any modification in the interpretation of overall strategy. The decline in interest rates would increase the demand for M-1 for any given level of activity; that factor had to be taken into account in defining the appropriate expansion of M-1 to maintain the same degree of downward pressure on prices that the original target had envisaged.

The staff had spoken of an easing of monetary conditions toward the end of 1982 because of declining interest rates and the exchange rate, as one Director had noted, the staff representative added, but it had not meant to imply that there had been an easing of monetary policy. Monetary

policy remained firm. However, as the rate of increase in the money supply decreased, inflation had decelerated also, thus opening up room for recovery within the context of the authorities' strategy. The U.K. authorities were concerned that observers should not interpret their policy stance as having eased.

One Director had asked whether the decline in inflation was really the result of monetary restraint, the staff representative remarked, or whether more weight should be attached to the appreciation of the pound as a result of the increase in oil revenues. No absolute answer could be given. However, the real appreciation of the pound could have been achieved in two different ways in response to the growth of oil as a factor in the U.K. balance of payments. One response to the increase of oil revenues might have been to expand demand rapidly, thereby driving up money wages; as money wages grew, the real exchange rate would appreciate. If that had happened, the increase in the real exchange rate could not have been attributed to monetary restraint, but rather to monetary ease. Instead, a restrictive monetary policy had increased interest rates, leading to a rise in the nominal value of the exchange rate. It could be argued, therefore, that a restrictive monetary policy had led to the appreciation of the exchange rate, which in turn had helped to moderate inflation.

A number of Directors believed that the authorities should set a separate target for the narrow money aggregate, M-1, the staff representative continued, because it was expected to rise more rapidly than the other monetary aggregates. At the time of the discussions between the staff and the U.K. authorities, the authorities had had the question under review. The staff believed that the acceleration in the growth of M-1 was the result of temporary shifts of demand into M-1 from the broader aggregates. At a time of such temporary shifts, it was difficult to judge how much of the shift needed to be accommodated and how much should be considered inflationary. Under those circumstances, there was much to be said for focusing on liquidity in general, and for accepting that sometimes one variable, sometimes another, might exceed or fall short of the overall target. When the staff had referred to the differential increase in M-1 and sterling M-3 as "an indicator of concern," it had wished to indicate that the more rapid increase in M-1 should be considered a temporary deviation in the face of monetary developments.

A number of questions had been raised regarding the use of the exchange rate as a supplementary indicator, the staff representative observed. The authorities' strategy focused on reducing the rate of inflation. Whether it was successful or not would depend on a number of factors. The exchange rate was one of several possible transmission mechanisms by which monetary restraint brought about a reduction in the rate of inflation. Its contribution to the control of domestic inflation depended in part on inflation rates among the country's trading partners as a whole. The rate of price increase of imports in foreign currency could be used to give a very approximate estimate of the degree of appreciation of the exchange rate that would contribute to the control of

domestic inflation. Of course, the exchange rate was affected not only by differential inflation rates. For example, the present developments in the oil market could have an unsettling effect on the exchange rate. Such disturbances emphasized the case for acting with caution as much with regard to the exchange rate as with regard to M-1, M-3, or any other monetary aggregate.

Commenting on fiscal policy, the staff representative noted that one Director had observed that the figures on government expenditure on page 30 of SM/83/21 differed from those given by Mr. Anson in his statement. The reason was that the two sets of figures were issued at different points in time. The figures used by Mr. Anson reflected revisions made by the U.K. authorities since the preparation of SM/83/21, and further revisions could be expected.

A number of Directors had suggested that the degree of success in bringing the public sector borrowing requirement (PSBR) under control suggested that there was room for relaxation of fiscal policy, the staff representative observed. It had also been suggested that the appropriateness of the PSBR should be judged in terms of a cyclically adjusted PSBR. The question of the appropriate size of the PSBR in the United Kingdom was, to some extent, a matter of judgment, on which views differed depending on the importance attached to lower interest rates as a means of stimulating activity or the value of a tax cut to industry as the mechanism for recovery.

There was insufficient empirical evidence to make a definitive judgment in favor of one approach over the other, the staff representative continued. It could be argued that a lower PSBR, by reducing the claims of the public sector on the supply of credit, might bring about a lower interest rate than would otherwise be the case. Other things being equal, the exchange rate could thereby fall, and both a lower exchange rate and the lower interest rate could improve the profit position of enterprises, reduce their cost of capital, and, thus, act as a stimulus to industry. An alternative view was that a larger PSBR resulting from a tax cut, such as a cut in the payroll tax, would not only reduce industry's costs directly, but that it would also act as a net stimulus to the economy through the increased demand for credit, thereby having an expansionary effect that would further stimulate industry. Given the present state of economic knowledge, a certain risk was involved in choosing between the two approaches. The authorities would make a decision based on the balance of risks at the time of their spring budget.

Some observers approached the debate from a different perspective, the staff representative added. They argued that a larger PSBR would raise interest rates above what they would otherwise be, thereby keeping the exchange rate higher, thus contributing to the fight against inflation. At the same time, even though the higher interest rate would suggest the probability of some "crowding out" as the result of the increased government deficit, the crowding out would not be 100 per cent. Therefore, there would be a net stimulus to activity as well as a net contribution

to the control of inflation. Those who held that view argued that it might be a better policy mix than that currently in effect. However, it was worth pointing out that the issue was a matter of slight differences in emphasis. As far as it could be quantified, it appeared that the effect of such a stimulatory approach was quite small in terms of the reduction in unemployment that could be expected from it. More fundamentally, although the crowding out would not be 100 per cent, there would undoubtedly be some crowding out within a given overall monetary target. To the extent that there was an impact on private investment, the balance between public expenditures and private expenditures would shift in favor of the public sector, instead of resulting in a recovery through private industry that was the major aim of the U.K. authorities. From the authorities' point of view, therefore, the balance of risk would tend not to favor an increase in the PSBR.

One frequently used measure of the room for reflation in the economy was the degree of unemployment, the staff representative observed. In the United Kingdom's case, it was high--13 per cent. Another indicator of the room for expansion was the balance of payments. The issue was what level of competitiveness would be compatible with what degree of reflation. The United Kingdom's current account position in 1982 had turned out to be stronger than the staff had expected, thus, the balance of payments constraint on expansion was weaker. However, it had to be borne in mind that the current account surplus had still shrunk as domestic demand had recovered, and it was projected to continue to shrink in response to further domestic expansion. To the extent that an expansion of domestic demand to the full employment level resulted in a substantial deterioration in the external accounts, so that serious downward pressure was exerted on the exchange rate, there would be upward pressure on prices, thereby constraining the degree of expansion that could be risked.

One Director had asked whether the staff had attempted to measure the natural rate of unemployment in the United Kingdom, the staff representative noted. The staff did not have a precise measure, but it took the view that the natural rate of unemployment was considerably higher when the external current account was weak than it would be if the external balance was strong. In other words, other things being equal, the noninflationary level of unemployment was much lower if an increase in employment had a substantial effect on the exchange rate. Thus, it could be argued that the limit to expansion, given the current level of wages in the United Kingdom, was not the level of unemployment but the weakness of the external account. It was worth noting that the latest information from the U.K. authorities, reflected in Mr. Anson's statement, indicated that manufacturing exports appeared to have at least held their market share, perhaps even increased it slightly, contrary to the staff's expectations. However, the loss of domestic market shares to imports remained serious.

To increase the room for expansion, competitiveness had to be improved, the staff representative went on, which involved a reduction in the real, not the nominal, rate of exchange. One Director had suggested that, if the case under discussion had been that of a developing country, the staff

would have pressed more vigorously for a change in the nominal rate of exchange. The distinction was not really between industrial countries and less developed countries, but between countries in which a change in the nominal exchange rate had an effect on competitiveness and countries in which such a change did not have that effect. Examples of developed and developing countries could be found in both categories. In the case of the United Kingdom, it was doubtful whether a nominal depreciation much beyond what had already occurred would have had a substantial effect. The effective exchange rate in January 1983 had been 10 per cent below that of January 1982, and 21 per cent below that of January 1981. Of course, the decline had not been smooth but had occurred in an irregular series of steps. The effect of a nominal depreciation on the real exchange rate in the case of the United Kingdom was limited because of the downward rigidity of wages. Observers across the political spectrum agreed that the downward inflexibility of real wages was a major institutional feature of the U.K. economy. Thus, use of an exchange rate depreciation to improve competitiveness had to be handled with care because of the danger that it could reignite inflationary expectations among wage bargainers.

The staff had stated in SM/83/18 that a depreciation would have to be "carefully limited," the staff representative recalled, meaning that movement in the exchange rate should be consistent with and give support to an anti-inflationary monetary policy. The staff had not intended to suggest that the authorities had intervened in the exchange market to achieve a particular exchange rate target. Intervention had been aimed at smoothing trends in the rate or, as in Mr. Anson's words, "to maintain orderly conditions in the market." There had been higher than usual official intervention in the exchange market in December 1982, and further intervention in January and February 1983. Compared to the intervention undertaken by other countries, it had not been large, and it appeared to have been aimed at the maintenance of orderly conditions.

Turning to developments in the labor market, the staff representative commented that a large part of the productivity growth had been the result of a shedding of labor by enterprises that was unlikely to be continued indefinitely. The question had been raised whether wage restraint could be maintained once the recovery was under way. Such a development probably required further institutional changes along the lines indicated in the staff report.

One Director had commented that capacity utilization was low, the staff representative remarked, a valid judgment if it was meant to indicate that the stock of capital was not being used as fully as might be desirable, or if it meant that the level of employment was low. However, judged against the balance of payments constraint, excess capacity was not great and effective capacity utilization could only be raised to the extent that wages could be brought under control. That possibility depended very much on the extent to which labor was prepared to price itself back into employment. While one Director had suggested that such a development might take a long time to achieve, some hopeful signs were emerging, as Mr. Anson had indicated. Wage bargaining was beginning to

take place increasingly at the plant level, where profitability considerations were important and where there was a greater likelihood that workers would make the connection between wages and employment more readily than they had done in the past. The suggestion had been put forward that the Government should become more active in the wage bargaining process by sponsoring a closer dialogue between management and labor. However, it seemed unlikely that such a dialogue could come to an agreement on reductions in the real wage. Reliance on increased competitiveness in the labor market was probably a more promising, albeit slower, approach.

Commenting on developments in the oil market, the staff representative observed that, in the early 1970s, when the price of energy had increased significantly, many industrial countries had responded by increasing rather than lowering the real wage. The increased cost of energy and of labor resulted in a severe squeeze on profit margins. At present, the outlook for both energy and labor prices appeared uncertain. The staff had made some very preliminary calculations of the effect of a reduction in the price of North Sea oil on the U.K. economy. A reduction of $3 a barrel in the price of petroleum would result in a decline of £1.5 billion, or 0.5 per cent, in the net contribution of oil to GNP. It would also represent a loss of about £700 million in government revenue, a reduction of about £500 million in the surplus on the balance of trade, and a decline of about 3.5 per cent in wholesale input prices and of about 1 per cent in wholesale output prices. On the same basis, i.e., that real magnitudes remained unchanged and only nominal magnitudes changed, the staff estimated that a 10 per cent decline in the sterling/dollar exchange rate would produce an increase in the net contribution of oil and gas to GNP of 0.5 per cent, thereby neutralizing the effect of the $3 a barrel decline in the price of oil. Similarly, a 10 per cent depreciation would approximately offset the effect of the decline in oil prices on government revenues and on the surplus of the balance of trade. The effect on wholesale prices, an increase of about 4 per cent, would be close to the 3.5 per cent decline resulting from a $3 a barrel oil price cut. In sum, the effects on the domestic economy of a decline of $3 a barrel in the price of North Sea oil would be offset through a 10 per cent depreciation in sterling. The estimates were rough, and the staff was looking forward to more detailed calculations produced by the U.K. authorities.

The suggestion had been made by one Director that the U.K. authorities could have accumulated reserves in anticipation of a period when oil prices might decline, the staff representative from the European Department noted. However, such a policy would have implied a more stringent anti-inflationary policy and, thus, a greater reduction in economic activity. In fact, the U.K. authorities had prepaid about $3.5 billion of foreign debt, so that at least some accumulation of reserves might have taken place. Finally, one Director had requested further information on the restrictions imposed on imports. The staff had provided considerable detail on import restrictions in SM/83/21; it would be pleased to provide the Director with further information direct, insofar as it was available.

Mr. Anson commented that the British National Oil Corporation (BNOC), the Government's oil trading agency, did not have control over crude oil production, which was in the hands of the oil companies. Changing the volume of oil that it bought under the participation agreements required six months' to a year's notice. BNOC had no storage capacity and no downstream operations. It had little choice but to follow market prices, as it had done in the previous week. It was worth placing in perspective the effect of North Sea oil on the U.K. economy: oil represented about 4 per cent of GNP and 6 per cent of tax receipts; net oil exports represented about 10 per cent of non-oil exports. Thus, the effect of a decline in oil prices on the U.K. economy was relatively modest, as the staff representative had indicated, particularly if account was taken of the recent decline in the exchange rate. Indirectly, a reduction in oil prices would contribute to the growth of the world economy and to the growth of world trade, from which the United Kingdom would benefit. Thus, the net effect of a lower oil price was likely to be beneficial in the long run, assuming that movements in the oil price remained moderate and orderly. It would be in no one's interest to see sharp changes in oil prices that created disturbances in the financial markets.

Commenting on incomes policy, Mr. Anson observed that the issue of a national incomes policy had to be judged in the particular circumstances of the United Kingdom. Although such policies had been attempted on earlier occasions, they had not generally proved effective in restraining incomes over an extended period. Evidence was emerging that labor market rigidities were gradually being reduced; the introduction of a national incomes policy was likely to run contrary to that development. Furthermore, it appeared from some recent Article IV consultation discussions with other countries that skepticism regarding incomes policy was increasing. However, it was a matter for the authorities in each country to judge in light of their own social and institutional considerations. The benefits of a "voluntary" incomes policy were also open to question; such a policy was often agreed to only in return for increased subsidies or social payments that could have adverse fiscal consequences. However, there was a valid case for discussion among the Government, employers, and trade unions on how best to obtain the common objective of sustainable growth and on the role of real wages and profits in achieving that goal. The National Economic Development Council provided a forum for such discussions.

The staff's view that the returns to the medium-term financial strategy had begun to come through "much as one might have expected" had elicited comments by Executive Directors, Mr. Anson noted. The U.K. authorities had stressed, when announcing the Medium-Term Financial Strategy, that it would take time for the benefits to be realized. If there had not been such large increases in wages in the earlier stages of the policy, the benefits might have been gained at a lower cost. Continued restraint in real wages would help to lower future costs of the strategy.

A number of Directors had stressed the importance of supply-side policies, Mr. Anson continued, such as measures to improve labor mobility and training. The U.K. authorities had given a great deal of attention

to such measures in recent years, and they would be ready to take further measures if they believed them to be effective. Much depended upon the response of management and employees to the incentives provided.

The prospects for investment had also been raised, Mr. Anson added. On the private side, the restoration of profitability would be the most important stimulus. On the public side, most of the fixed capital formation was undertaken by local authorities in light of local needs, or by the nationalized industries in light of their commercial judgment. The need for capital expenditures in the social sector had declined to a considerable extent because of such factors as the fall in the school population. In addition, local authorities had to consider whether they could afford the current costs resulting from capital expenditures at a time when current costs were being controlled. One Director had suggested, apparently misunderstanding the situation, that local authorities were being penalized for capital expenditure. While it was true that there had been arrangements under which local authorities that spent more in total than had been planned suffered a reduction in government grants, the general thrust of policy in the previous 12 months had been to encourage capital expenditure by the local authorities and to encourage them to apply for supplementary provisions for that purpose.

Nationalized industry investment had to be justified on its rate of return, Mr. Anson pointed out, a rate that was at present lower than that in industrial and commercial companies. It would therefore be inappropriate to force the nationalized industries to invest if the resources could be more profitably used elsewhere. The public expenditure plans for 1983/84 indicated that capital expenditure was planned to be about 12 per cent above the outturn for 1982/83 and construction in the public sector was planned to be about 10 per cent higher. Progress was continuing with regard to the return of part of the public sector to the private sector. Inter alia, the offshore oil interests of British Gas and parts of the telecommunications sector were scheduled to be sold to the private sector.

The exchange rate and the size of the fiscal deficit were related issues, Mr. Anson commented. The authorities had been concerned to reduce the fiscal deficit as a proportion of GDP and they had achieved that goal to a considerable extent. The staff had referred to that policy as "a policy of austerity." However, if, as one Director had commented, the policy was designed to reduce taxes, to reduce the PSBR, and to encourage a decline in interest rates it was not a policy of austerity; rather it was based on a judgment about the appropriate balance between the public and private sectors in the economy. Some Directors had suggested that it would have been desirable to attempt to achieve the same objective with a lower exchange rate. Other things being equal, such a policy would have implied an even lower fiscal deficit. In the end, the appropriate level of the budget deficit was a matter of judgment, as the staff had indicated on page 11 of SM/83/18. The Government's objective remained to reduce the deficit/GDP ratio over time.

The relationship between the exchange rate and monetary and financial conditions was not necessarily rigid, Mr. Anson considered, and it should be approached pragmatically. On the question raised by Mr. Erb about the relevant exchange rate with regard to monetary policy, the authorities had focused primarily, but not exclusively, on the nominal effective rate. Of course, the real effective rate had also been a significant economic indicator as a measure of competitiveness. Individual rates, such as the dollar rate or the deutsche mark rate, mattered in the sense that they provided indications of the relative currency preferences of asset holders. But it would not normally be appropriate to use one rate, even the dollar rate, as the main indicator for monetary policy purposes, if only because such a rate was subject to the external and, to some extent, internal, pressures in the country whose currency it was.

The crucial question was the appropriate overall stance of monetary policy at the present juncture, Mr. Anson observed. Some Directors had wondered whether there was a case for relaxing monetary policy on the grounds that the high level of unemployment would act as a restraint on inflation. However, the level of unemployment might not prove to be a sufficient restraint, because wage negotiators, de facto, tended to represent the employed rather than the unemployed. Once unemployment was falling, they would be less concerned about the effects of their actions on employment prospects in the short run.

The Government had to continue with its cautious policy until inflationary expectations had been overcome to a considerably greater extent than had occurred so far, Mr. Anson stated. The authorities would seek to make an informed judgment on the room for new fiscal measures and on the monetary targets; they did not pursue monetary policy in a dogmatic fashion, but in the light of developments, both external and internal. They had been prepared to overshoot the monetary targets when circumstances deemed such a response appropriate; in the previous budget they had set a revised target, on the basis of circumstances at that time, which had been observed in the ensuing 11 months. Policy would continue to seek to restrain inflation through appropriate monetary targets, taking account in a balanced way of other indicators, including the exchange rate. The fiscal and monetary decisions to be made in the forthcoming budget would be taken in that context.

The Acting Chairman made the following summing up:

> Directors warmly commended the U.K. authorities for the success of their anti-inflationary policies, which, it was stressed, had been much more striking than earlier expected. However, bearing in mind that the effects of the recent significant depreciation of the pound had yet to be reflected in retail prices, most Directors concluded that the prospects for consolidating the recent gains in dampening inflation hinged critically on further substantial moderation of pay settlements.

While recognizing that pay increases had slowed down markedly since 1981, Directors nevertheless viewed with concern the fact that wage increases were still rising much more rapidly than prices at a time of little, if any, growth in real national income. That development had tended to retard progress in restoring profitability and international competitiveness in the non-oil traded goods sectors, despite the quite exceptional growth in productivity that had recently been achieved. Recognizing the limitations of incomes policy in the U.K. context, some Directors nevertheless thought that progress in containing incomes could be enhanced by a more active role of Government in the establishment of wage guidelines and in enhancing constructive dialogue regarding the labor market among the interested parties.

Directors stressed that the emphasis the authorities had placed on financial restraint in combating inflation, coupled with the slow response of wages, had resulted in very large costs in terms of forgone output and increased unemployment. The large shedding of labor by hard-pressed enterprises, particularly in manufacturing, had contributed to raising unemployment to a very high level with relatively little prospect of early improvement. Most Directors nevertheless considered the strategy pursued to have been necessary to lay the basis for sound growth in the medium term.

Speakers generally welcomed the increased flexibility that the authorities had shown, especially in the budget for 1982/83, in adjusting their specific monetary and fiscal targets in the light of changing circumstances while adhering to the broad anti-inflationary thrust of the Medium-Term Financial Strategy (MTFS). That flexible approach, together with the rapid abatement of inflation, had provided the basis for the recovery in real money balances and domestic demand that was now under way and that, Directors hoped, would lead to a broadly based upturn in domestic output and employment before long.

There was general agreement that the poor rate of return on capital and the unsatisfactory level of international competitiveness were the main obstacles that had to be overcome if the eventual pay-off of the MTFS in the form of sustained expansion in output and employment was to be realized.

Some Directors felt that exchange rate policies should be pursued in a more flexible manner in order to help eliminate the remaining distortions in relative prices and to arrest the tendency for the United Kingdom to lose market shares at home and abroad. Most Directors, however, agreed that too rapid a depreciation of the exchange rate would risk a reacceleration of the rate of inflation, which had been brought down at considerable cost. Therefore, they stressed that continued and accentuated moderation in wage settlements should remain the critical element in the control of inflation and in the improvement in

international competitiveness. In that respect, Directors commended the authorities' continuing efforts through legislation and other means to restore the balance in industrial relations. The importance of labor mobility and manpower training measures was also stressed.

Some Directors believed that in view of recent trends in unemployment, capacity utilization, prices, and the balance of payments, the emphasis of economic policy should be shifted toward stimulating growth. They believed that there was scope for some relaxation of fiscal policy and that monetary policy should be eased. Most Directors, however, felt that the current stance of monetary policy was generally well balanced and appropriate. Some adjustment in the quantitative targets for the main aggregates might be necessary from time to time, but the room for maneuver remained limited.

With regard to fiscal policy, the reduction of public expenditure as a proportion of GDP, which was becoming apparent, was welcomed by a number of Directors. Most Directors agreed that the present projection of the public sector borrowing requirement (PSBR) for 1983/84 was within the appropriate range. If room could be found for fiscal adjustment in the forthcoming budget, it was felt that the emphasis should be on improving the cost competitiveness of industry.

Some Directors noted with concern the recent increase in the strength of protectionist pressures in the United Kingdom and they urged the authorities to resist firmly such pressures. While noting with approval the sizable private financial flows to developing countries, Directors also welcomed the real increase in development assistance planned for 1983/84 and they encouraged the authorities not to scale down such assistance.

The Executive Board concluded its discussion of the 1982 Article IV consultation with the United Kingdom.

2. MAURITANIA - 1982 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1982 Article IV consultation with Mauritania (SM/82/246, 12/30/82; and Sup. 1, 2/18/83). They also had before them a report on recent economic developments in Mauritania (SM/83/10, 1/20/83).

Mr. Alfidja made the following statement:

On behalf of my Mauritanian authorities, I wish to thank the staff for the comprehensive set of documents it has prepared on the 1982 Article IV consultation with Mauritania. As usual, the reports are of an excellent quality and give a pertinent analysis of the country's economic and financial problems.

After the severe and protracted drought of the early 1970s, and thanks to substantial flows on concessionary terms from friendly countries and international financial institutions, the Mauritanian authorities embarked on a large and determined investment policy. While such an undertaking, which aimed at expanding the country's infrastructure and creating an industrial base, was fully justified, it led, together with the Western Sahara-related expenditures and a deterioration of the Mauritanian terms of trade, to increasing financial domestic and external imbalances.

As the staff points out, in 1979 the Mauritanian authorities decided to withdraw from the Saharan conflict and to implement various adjustment measures to correct these imbalances. The adjustment measures were embodied in a medium-term rehabilitation plan prepared with the assistance of the World Bank. In order to carry out the plan, Mauritania entered two successive stand-by arrangements with the Fund, the main objective of which consisted in:

(1) restraining domestic demand by appropriate wage and fiscal policies; and

(2) encouraging supply by structural reform in the public enterprise sector, the fishing sector, and investment policy.

The Mauritanian authorities implemented most of the adjustment policies contained in the two stand-by arrangements and as a result, most of the program's targets were achieved and the performance criteria met. Real GDP increased at an average rate of 5 per cent during 1979-82. Inflation, as measured by the consumer price index for European-type goods, was under control at 12 per cent in 1982; it was even lower for basic foodstuff consumed by low-income groups.

On the budget front, the Government froze the salaries for civil servants and no recruitment was carried out. As a result, government expenditures declined every year through 1982 except in 1981. Even for that year, if one takes into account the inflation rate, government expenditures declined in real terms. This government policy of austerity and restraint failed, however, to result in a concomitant reduction of the overall budget deficit, because of a less satisfactory performance on the revenue side. In 1982 in particular, there was a substantial shortfall in tax and nontax receipts from the promising fishing sector. As the staff has pointed out, the main reason for the weak revenue performance is the lack of a well established administrative machinery required to assure proper tax collection and combat tax evasion. Mauritania's tax administration problems are deeply rooted in the structure of its society as well as the size of the country's

borders. They will take some years to be corrected. The recent adoption of a new tax code and the determination of the authorities to continue to enforce a strict budgetary discipline are in the right direction and will generate a new momentum.

With regard to the structural reform of the public enterprise sector, after a successful restructuring of the leading enterprise, namely, the Société Nationale Industrielle et Minière (SNIM), and the implementation of tariff adjustments for water and electricity, the Government introduced sharp price increases for basic commodities sold by the Société Nationale d'Importation et d'Exportation (SOMINEX) and succeeded in reducing significantly the losses of the latter. The Mauritanian authorities are fully committed to continuing this policy in the years ahead. With the help of the World Bank, three enterprises have been selected for a thorough study in order to improve their financial management.

In the monetary field, efforts to strengthen the financial structure of the banking system and to reduce the existing liquidity overhang are being pursued through a comprehensive reorganization of the banking system with a view to further improving the efficiency of the financial system and facilitating overall credit management and control. The authorities intend to continue a selective credit policy geared to financing the real needs of the economy in general, and the productive sectors in particular.

With regard to the external sector, after some improvement recorded in 1981, the balance of payments of Mauritania weakened in 1982 and is expected to deteriorate further in 1983. This is due, as explained by the staff, to a softening in the demand for Mauritania's main exports--iron ores and fish--and to increasing imports payments related to investment projects and oil products.

During the same period, the current account deficit remained high even though its financing has proved feasible so far on concessionary terms. One cannot but share the staff concern about the weakness in the medium-term prospects for the balance of payments as this weakness might require further borrowing. The Mauritanian authorities are planning to obtain appropriate debt relief through bilateral negotiations with friendly donor countries. In this regard, the Government has set up a committee in charge of these negotiations. Regarding the exchange rate policy, my Mauritanian authorities have stated their policy to the staff and I would like, on their behalf, to thank the staff for the fair and clear manner in which the divergent views of my authorities and the staff are described on page 19 of SM/82/246. As indicated on the same page, the Mauritanian authorities stand ready to review the matter in the near future with the staff and management.

I would therefore urge the Executive Directors not to consider the subject in a too rigid way for the time being and to leave enough flexibility to management and my authorities to reach a mutually acceptable understanding on this very sensitive question.

Miss Le Lorier commented that the resumption of Article IV consultations with Mauritania was welcome, particularly because of the significant progress achieved, although further progress would be necessary. She fully shared the staff's view that "a combination of external financing and strong internal measures should be implemented to bring about the necessary reductions in the imbalances in an orderly and efficient way." There was little doubt that Mauritania was in need of foreign assistance, both financial and technical. The fact was duly acknowledged in the staff report through the presentation of the various fiscal and external indicators. However, reliance on external assistance could not bring about the desired effects in development if too little attention was paid to the correction of internal imbalances. It had to be emphasized firmly that borrowing, even at concessionary terms, and rescheduled debts needed to be serviced. Those constraints fully justified the thrust of the recommendations made by the staff.

Exchange rate adjustment was frequently advocated by the Fund in order to restrain demand, Miss Le Lorier continued. In Mauritania's case, much more was at stake. The correction of the recent imbalance arising from the appreciation of the ouguiya appeared to be the only way of regaining some influence over the development of the economy and of preventing the emergence of a dual economy with an official, but unbalanced, sector and an unofficial, unrecorded sector. The position was well substantiated in the staff report; the comprehensive and balanced discussion on page 19 of SM/82/246 of the various issues involved was most convincing.

If the authorities were prepared to take action, as recommended by the staff, Miss Le Lorier remarked, the action might have to be accompanied by a significant increase in wages in order to allow for a full but tolerable pass-through of the effect of the devaluation on domestic prices of imported essential goods. Such an approach would be preferable to the use of increased customs duty receipts as a means of granting larger subsidies on such goods. She invited the staff to comment on the appropriateness of the present level of wages.

Fiscal policy also needed strengthening, Miss Le Lorier considered. Mauritania's situation was somewhat unusual, since one policy objective would be to increase significantly and steadily the Treasury's receipts from the economy. Chart 2 in SM/83/10 showed that a declining budget/GDP ratio did not guarantee a sustained reduction in the budget deficit. The authorities should be commended for their determination to contain the rate of growth of expenditures, but their efforts seemed to have reached the point where they were resulting in payments arrears, both internally and externally, rather than laying the foundation for a viable fiscal

position. She urged the authorities to undertake decisive action on the revenue side along the lines suggested by the staff. As Mr. Alfidja had pointed out, a lasting improvement would take time to achieve and it would depend in part on exchange rate action. The structural character of the deficit was an additional reason to take the initial steps quickly. At the same time, the reduction of the operating losses of public enterprises should be pursued; she welcomed the comprehensive review undertaken by the Government with the assistance of the World Bank, as well as the creation of an interministerial committee for the rehabilitation of public enterprises.

Commenting on financial policy, Miss Le Lorier noted that the staff had correctly refrained from emphasizing interest rate management. The most urgent task was undoubtedly to update the management capabilities of the banks, while strengthening central bank monitoring of their operations. She fully supported the assistance provided by the Fund in that area. The fragility of the available data underlined the need to improve the data base. While such progress would take time, improvement in two areas was urgently needed. In the fiscal area, the various budget accounts required consolidation; furthermore, she regretted that comprehensive and updated information on external debt had not been provided to the Fund, and she hoped that the authorities would provide the necessary information in the very near future.

The specific characteristics of the Mauritanian economy did not make adjustment and development incompatible, Miss Le Lorier added. A Fund program to deal with the situation could be designed flexibly. She noted that the pricing of food items was aimed at discouraging rural-urban migration. Such a practice need not be discontinued, provided that the overall situation of the trading companies remained in balance. She invited the staff to comment on that point. She supported the proposed decision; she hoped that discussions between the Fund and Mauritania could be resumed quickly in order to conclude a new arrangement.

Mr. Suraisry noted that the Mauritanian economy suffered from difficult economic and financial problems as a result of both internal and external factors. The successful economic performance achieved as a result of the 1978-81 corrective measures had come to an end. Consequently, the economy had deteriorated, and strong adjustment measures were warranted.

The authorities had undertaken commendable measures to restrain expenditures, Mr. Suraisry continued. However, fiscal performance had not been strong, a condition that was expected to continue mainly because of weakness on the revenue side. Such weakness had to be corrected if the imbalances in the economy were to be sufficiently addressed. He sympathized with the authorities' arguments, presented on page 15 of SM/82/246, concerning the limited efficiency of the tax system. Without modern techniques and social awareness of the function of taxation, it was difficult to achieve an efficient tax system. However, the present system could certainly be improved and he emphasized the importance of the technical assistance that the Fund might provide.

The financial potential of the fishing sector was impressive, Mr. Suraisry observed, and, despite the authorities' achievements with regard to the revenue yield from that sector, further progress could be made. He noted that the authorities were focusing on the sector and its potential foreign exchange earnings as a means of assisting in the adjustment of the economy. The mining sector was also expected to increase foreign exchange earnings, but an improvement would depend on the world recovery. He noted with satisfaction the authorities' efforts to develop the agriculture sector and to increase its contribution to GDP. However, the chance of success would be greater if the authorities implemented the planned incentive policies.

The country's external balances were an area of great concern, Mr. Suraisry added. External debt outstanding in 1981 had been almost 132 per cent of GDP and the debt service ratio had been a little over 20 per cent. The picture for 1982 was little better. The authorities had to monitor the debt area very carefully; otherwise the situation would be difficult to manage and it could severely complicate their adjustment efforts. If adjustment was to succeed, structural measures would be needed. In that regard, he welcomed the authorities' present review of the operations of the major public enterprises. He was confident that it would help to improve economic management, which was a necessary factor in dealing with the current economic problems. He commended the authorities on the maintenance of a free trade system.

Mr. Abiad said that the authorities had taken courageous and wide-ranging adjustment measures between 1979 and 1981, aimed at reducing the mounting domestic and external real and financial imbalances. The measures had been part of a transitional financial program supported by Fund resources; they had been successfully implemented, and they had led to impressive results. The growth of domestic output had recovered rapidly, exports had expanded, and the budget and external deficits had been reduced.

The performance of the economy in 1982 appeared to be much less impressive, largely as a result of exogenous factors, Mr. Abiad continued. The continued recession in export markets had resulted in a decreased demand for Mauritania's major exports, particularly iron ore, thereby hampering the authorities' efforts to further the adjustment process and to expand production and export capacity. The outcome in 1982 appeared disappointing relative to the considerable progress achieved in the earlier period.

Commenting on Mauritania's relations with the Fund, Mr. Abiad observed that developments in 1982 had highlighted the underlying large internal and external imbalances; those developments had confirmed that the difficulties facing the Mauritanian economy were, to a large extent, structural. The reduction of imbalances and progress toward the restoration of a viable equilibrium in the medium term called for the pursuit of a balanced mix of restrained demand management and supply-oriented policies in an appropriate time frame and with adequate financing. On page 10 of SM/82/246, the staff noted that "the consultation discussions were conducted in

conjunction with exploratory discussions on a comprehensive new adjustment program...supported by use of Fund resources in the near future." In that regard, he recalled that, in July 1980, at the time of the Board discussion of the initial stand-by arrangement with Mauritania that ended in March 1982, the stand-by arrangement had generally been considered a transitional step toward the adoption of an extended arrangement. He invited the staff to comment further on the prospects for such a medium-term program with the Fund.

With regard to Mauritania's investment policy in the context of the 1981-85 development plan, Mr. Abiad went on, the staff indicated on page 12 of SM/83/246 that the authorities, with the technical assistance of the World Bank, were engaging in a review of the "programming of investments and their financing so as to allow an overall assessment of their medium-term impact on the budget, the balance of payments, and the external debt servicing." It would be useful to know the main preliminary conclusions of the review, if available, as well as the changes in circumstances that had necessitated such a review, particularly in view of the close collaboration of the authorities with the World Bank staff in the preparation of the current plan.

Mr. Dallara remarked that, from mid-1978 until the end of 1981, the Mauritanian authorities had been able successfully to implement a number of important measures in the context of an adjustment effort that had been supported by Fund resources. Despite difficulties and shortcomings, as well as adverse exogenous developments, progress had been achieved during that period. Continuing, and in some areas, more vigorous, adjustment ought to have occurred in 1982; unfortunately, that year had witnessed substantially higher imbalances, both externally and internally, as a result of weaknesses in the effective implementation of certain key policies. The latest economic data, provided in the supplement to SM/82/246, indicated that, although the actual outturn for 1982 had proved better than had been expected earlier, the situation remained critical.

Given the extreme difficulties currently facing Mauritania, Mr. Dallara continued, it was necessary for the authorities to make a serious effort to implement a comprehensive new adjustment effort. The Fund staff and management had approached the question of a renewed adjustment effort in an appropriately cautious manner, and he fully agreed with the policy recommendations contained in the staff appraisal. The key to improved financial prospects was a better fiscal performance. Despite the inherent difficulties in trying to raise revenues in an environment in which the population viewed income taxes as inconsistent with its values, the staff's argument that there were a number of areas in which tax collection could be substantially improved were convincing. He urged the authorities to implement the staff's recommendations in that regard.

The level of interest rates had remained basically unchanged since 1973, Mr. Dallara noted, although there had been an adjustment in 1980. The rate structure was low in comparison to rates prevailing in similar countries, or compared to the local inflation rate. He invited the staff

to comment further on the nature and extent of the required changes. He fully agreed that the recent appreciation of the exchange rate had to be corrected. Chart 5 of SM/83/10 indicated the dramatic appreciation of the real exchange rate in the previous two to five years. Given the failure of the authorities to carry out the understanding with regard to the exchange rate during the previous program, an appropriate adjustment in the rate should be one of the first steps in any renewed adjustment effort.

Mr. Salehkhou commented that Mauritania's economy had had good periods and bad periods in the previous few years, coinciding with periods of regional conflicts, adverse external market conditons, drought, and other natural calamities. A combination of such difficulties had led to serious external and internal imbalances. The authorities had responded to the unfavorable developments with a rehabilitation plan assisted by the World Bank, and through a stand-by arrangement with the Fund that had ended in March 1982. The stand-by program had been effective to a considerable extent; Mauritania had been able to redress some of the disequilibria that had appeared in the economy and to pave the way for a possible future recovery. However, structural problems remained, mainly in the areas of taxation, project implementation, public enterprises, and the banking system.

Under the Fund's 1981-82 adjustment program, Mr. Salehkhou continued, the overall budget deficit had been reduced by 50 per cent to 9 per cent of GDP, the net increase in domestic credit had declined to 16 per cent of GDP, and the overall balance of payments had shown a surplus in 1981, compared with the original target projection of a sizable deficit. Among the measures not implemented were reductions in tax exemptions and reductions in the short-term foreign liabilities of banks. In the real sector, despite a good harvest, overall economic growth had slowed down considerably in 1982, due mainly to a decline in the modern sector of the economy. Weak iron ore output, low fish production, electricity shortages, and problems in other areas had contributed to the slower pace of economic growth.

Within the framework of the new development plan, Mr. Salehkhou observed, priority would be given to developing mineral, fishing, and agricultural resources and to expanding the country's transportation infrastructure. Ambitious investment outlays were projected in those areas. Fiscal performance had been unsatisfactory in 1982 and the fiscal deficit was estimated to have risen to 13 per cent of GDP, reflecting stagnation in government revenues and a slight increase in total expenditure. The authorities' performance in restraining government expenditure had been encouraging. However, there was clearly an urgent need to reduce tax evasion and to improve tax administration and collection.

Commenting on monetary policy, Mr. Salehkhou welcomed the recent measures taken by the Central Bank, with the aid of Fund technical assistance, to strengthen the financial structure of the banking system and to reduce the liquidity overhang. However, there was a need to move

cautiously on domestic credit, since it had expanded rapidly in 1982. Total domestic bank credit was likely to cause a sharp increase in the net foreign liabilities of the banking system.

The good performance of the external sector prior to 1982 had not continued, Mr. Salehkhou noted, and the current account deficit was expected to reach 46 per cent of GDP, mainly due to a decline in export earnings. There would be a relatively large balance of payments deficit that would probably be financed by a buildup of payments arrears. External indebtedness was a heavy burden and urgent debt relief and grants were needed to ease the pressing problems in the external sector. An extended arrangement program with the Fund was the best course open to the authorities in order to continue the earlier gains and to rectify some of the imbalances.

The staff representative from the African Department said that the staff fully recognized that the data base in Mauritania was extremely fragile, particularly with regard to information on external debt and public finances. The Fund had already provided technical assistance to the Mauritanian authorities in the context of staff missions for Article IV consultations, but there was a limit to what could be done in that way. In view of the magnitude of the external debt burden and the arrears accumulated over the previous two years, the staff believed that additional technical assistance on a more formal basis would be needed in the coming months in the context of the preparation of a Fund-supported program. The World Bank was planning to provide technical assistance in the review of the public enterprises, focusing initially on four enterprises. However, no conclusions or recommendations were available at present; it was unlikely that the results of the review would be available at the time of negotiations for a possible program with the Fund.

Interest rates had been consistently negative in Mauritania, the staff representative noted. However, in view of the major problems of management and of the high level of bank indebtedness of public enterprises, the Mauritanian authorities believed that an increase in interest rates would simply increase the losses of the public enterprises without reducing the incentives to borrow. At the same time, the banking system in Mauritania was extremely narrowly based; for all practical purposes it was limited to five banks in the capital city. Thus, the interest rates on deposits played a minor role; nevertheless, the staff intended to continue to discuss with the authorities the possibility of an increase in interest rates to a level consistent with those prevailing in neighboring countries.

It was difficult to determine what would be the appropriate exchange rate level in Mauritania's case, the staff representative continued, or the likely short-term and long-term effects of a change in the rate. Although the authorities agreed that some change would be necessary, a large discrepancy remained between their views and those of the staff. There had been a substantial appreciation of the effective exchange rate over the previous two years and, whatever agreement was reached on how to correct it, the correction would have an effect on real wages in a country

in which they had already declined by 40-50 per cent over the previous four or five years. The authorities were extremely concerned about a further reduction in the real wage that would inevitably accompany a full pass-through of all the effects of the change in the exchange rate. The negative effects could be offset by an increase in wages to a certain extent, but there were limits to that solution also because of the impact it would have on the budget deficit. There was also a limited amount of subsidies that could be granted, as well as a limit to the price increases allowed in consumer goods to offset the subsidies on essential items such as rice, sugar, and tea. The problem remained unresolved.

Although the possibility of an extended arrangement had been discussed at the time of the negotiations of the stand-by arrangement in 1980, the staff representative from the African Department recalled, such a possibility was difficult to envisage at the present stage. First, the restoration of a viable external position would take many years, much longer than the period normally associated with an extended arrangement. Second, Mauritania would be faced with large external deficits for many years and it was not clear how those deficits would be financed in the short term, let alone the medium term. Third, the institutional and administrative weaknesses made it difficult to assess the effect of policy actions in the short term, and even more so in the medium term. The staff believed, therefore, that a stand-by arrangement of one year or 18 months would probably be a more appropriate framework in which to set quantitative targets that would be less likely to deviate too much from initial estimates.

Mr. Alfidja remarked that, although differences of views existed between the staff and his authorities, as the staff representative had pointed out, they should not be overstated. The authorities would seek to cooperate with the staff during the forthcoming mission, particularly on the exchange rate problem. A number of questions remained to be settled with regard to the appropriateness of fiscal and monetary measures as well.

The appropriateness of a medium-term program for Mauritania had been highlighted by Mr. Abiad, Mr. Alfidja suggested. Although it was true that institutional problems existed, they were not insuperable and a medium-term program could be seen as a learning process through which the authorities could improve upon their efforts to date. The problem of the current account deficit had been overemphasized by the staff; it was one faced by many countries in Africa. A medium-term program could also take into consideration the difficulties associated with the inadequacy of the data base.

The question of interest rate policy had also been raised, Mr. Alfidja noted. Interest rates were, of course, important, but when the financial system functioned only in a rudimentary way, interest rates became a secondary factor in the direction and magnitude of capital flows. He hoped that the forthcoming discussions between the staff and the Mauritanian authorities would be fruitful and that they would enable Mauritania to enter into a program with the Fund that took account of the specific nature of the problems facing the country.

The Acting Chairman made the following summing up:

Executive Directors generally concurred with the thrust of the views contained in the staff appraisal. Directors noted that the Mauritanian authorities had implemented most of the adjustment measures contained in the recent stand-by programs and that they had met the performance criteria. They cited the restrained wage and budget expenditure policies and the restructuring of the mining company.

However, Directors stressed with great concern that the external and budgetary situations had deteriorated in 1982 and that a further significant deterioration was foreseen for 1983. Given the magnitude of imbalances in the economy and the weakness of world trade, determined and comprehensive efforts would be required in 1983 and in subsequent years to restrain aggregate demand, to improve economic efficiency, and to restore external equilibrium. Directors mentioned, in particular, the need for readjustment of the exchange rate--fully recognizing that that was a particularly difficult matter; for a significant reduction in the budget deficit; and for strengthened monetary policy.

Directors viewed with concern the lagging pace of policy implementation with respect to tax revenue and tax administration. Further progress in stimulating agricultural and fishing output and in the rehabilitation of public enterprises was also seen as urgent.

Directors noted that external obligations were so large that internal adjustment would have to be accompanied by a substantial restructuring of external debt servicing and by sufficient new external assistance on concessional terms for capital investment.

Some Directors noted that the authorities' ability to implement a suitable adjustment program could be greatly assisted by improved administrative capacity, a better statistical base, and, in that context, further Fund technical assistance.

The Executive Board then took the following decision:

Decision Concluding 1982 Article XIV Consultation

1. The Fund takes this decision relating to Mauritania's exchange measures subject to Article VIII, Sections 2 and 3, and in concluding the 1982 Article XIV consultation with Mauritania, in light of the Article IV consultation with Mauritania conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The Fund notes that, despite the pressures on the balance of payments, Mauritania's exchange system has remained relatively free of restrictions. In view of the circumstances of Mauritania, the Fund approves the restrictions on the sale of foreign exchange for travel and salary remittances, until March 31, 1984 or the next Article IV consultation, whichever comes first. The Fund would urge Mauritania to eliminate its external arrears as soon as possible.

Decision No. 7336-(83/36), adopted
February 23, 1983

3. BRAZIL - REPORT BY ACTING MANAGING DIRECTOR

The Acting Chairman stated that, on the previous day, he had sent a message to 42 commercial banks involved in financial negotiations with Brazil. The message read:

> I have received information from the coordinating banks involved that your bank's outstandings in money market operations with Brazilian bank agencies and branches abroad are below the fair share amount in recent weeks by an amount approximating US$20 million or more. I wish to convey to you that I am extremely concerned with this situation. In the absence of contrary indication, I must interpret the current situation of your bank as evidencing failure to cooperate in the effort to support Brazil. I permit myself to express the hope that you will cooperate fully by increasing current money market outstandings at once.

He had sent the message, in his capacity as Acting Managing Director, to six banks in Italy, five in Germany, five in the United States, four in France, four in Kuwait, four in the United Kingdom, three in Austria, three in Japan, two in Switzerland, and one bank each in Belgium, Canada, Hong Kong, the Netherlands, Pakistan, and Saudi Arabia.

The Executive Directors took note of the Acting Chairman's remarks.

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/83/35 (2/23/83) and EBM/83/36 (2/23/83).

4. FIJI - TECHNICAL ASSISTANCE

In response to a request by the authorities of Fiji for technical assistance, the Executive Board approves the decision set forth in EBD/83/40 (2/16/83).

Adopted February 23, 1983

APPROVED: July 25, 1983

LEO VAN HOUTVEN
Secretary