INTERNATIONAL MONETARY FUND
Press Information Notice
EXTERNAL RELATIONS DEPARTMENT

Press Information Notice (PIN) No. 97/34
FOR IMMEDIATE RELEASE
November 6, 1997

International Monetary Fund
Washington, D. C. 20431 USA
www.imf.org

IMF Concludes Article IV Consultation with United Kingdom

The IMF Executive Board on October 27, 1997 concluded the 1997 Article IV consultation[1] with United Kingdom.

Background

During the past year, the United Kingdom's impressive economic performance has continued. With the upswing now in its fifth year, GDP growth has accelerated to 4 percent, virtually eliminating slack, while inflation has declined close to the official target of 2½ percent. Domestic demand has been the main driver in the pickup of growth. Consumer spending is rising at 6 percent a year; personal disposable income is growing rapidly, unemployment falling, and consumer confidence at a 10-year high. Investment has been more sluggish, rising only 1 percent between the second quarter of 1996 and the second quarter of 1997, mainly reflecting a sharp fall in public investment (by over one fourth since a year earlier to 2½ percent of GDP); in contrast, private non-residential investment grew by close to 10 percent with buoyant demand and strong corporate profits.

This favorable performance, however, is being threatened by emerging imbalances. The strong growth in domestic demand, boosted by consumer windfalls from stock market flotation of former mutual associations and by tax cuts, has been accompanied by a sharp rise in sterling—nearly 20 percent in effective terms since August 1996. Sterling's appreciation, which can be partly

[1]Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. In this PIN, the main features of the Board's discussion are described.

explained by the relative cyclical positions of the United Kingdom and continental Europe and associated expectations of divergence in monetary policy stances, and possibly EMU-related portfolio shifts, is likely to bring a substantial deterioration in net exports. It has already contributed to a widening gulf between buoyant services and weaker manufacturing, which, after recovering somewhat during 1996, is looking frail again. Manufacturing export orders are at their lowest since November 1993, suggesting further slowdown over the coming months.

Thanks to strong sterling and the resulting fall in input prices, inflation reached its official target of 2½ percent in April (based on the officially targeted measure that excludes mortgage interest). It rose again to 3 percent in July, mainly reflecting indirect tax increases in the July budget, as well as some seasonal factors, before falling to 2.7 percent in September.

The labor market has continued to tighten, with unemployment falling to a cyclical low. It is now below the G-7 average and well below levels elsewhere in Europe. The official unemployment rate (5.2 percent in September based on the claimant count) and other indicators confirm that unemployment is close to its previous low. Wage pressures, although subdued by past standards, have strengthened since last year, with average earnings up 4½ percent in August over a year earlier, close to the limits of consistency with the inflation target.

Four years of fiscal consolidation, guided by a medium-term plan aimed at balance have brought about a clear improvement from an unsustainably weak fiscal position in 1993. The Public Sector Borrowing Requirement (PSBR) for 1996/97 was 3.6 percent of GDP, ½ percent of GDP lower than projected in the 1996 budget and close to that forecast in the 1995 budget, largely reflecting better-than-expected revenues. Nevertheless, the fiscal deficit in structural terms, at 2.8 percent of GDP in 1996/97, remained among the largest in major industrial countries. Presently, the July 1997 budget envisages a significant fall in both actual and structural deficits by the end of the present fiscal year as a result of tax measures and lower projected real spending.

In the context of the inflation-targeting framework, the authorities have raised official interest rates by a cumulative 1¼ percentage points over the past year to 7 percent, with 1 percentage point of it since the new government took over in May. The new Chancellor of the Exchequer raised the rates by 25 basis points soon after taking office, at the same time as he announced the decision to give the Bank of England operational independence; and the Monetary Policy Committee of the Bank has raised them by a further 75 basis points since then. Long-term yields are lower by 165 basis points from a year ago, with the spreads over Germany recently below 100 basis points. Rapid growth in monetary aggregates has continued, with M4 growing by almost 12 percent in the year to June; and net consumer credit has risen faster. Asset prices have also been rising strongly, with the stock market and house prices rising by around 20 percent and 6 percent, respectively, over the past year.

The new government has also embarked on an ambitious structural agenda. Reforms affecting the labor market include a Welfare-to-Work program that seeks to enhance employability for the long-term unemployed, especially youth, through job training and subsidies; a comprehensive review of the tax and benefit system with the objective of strengthening work incentives; and a national minimum wage to be set at a level to be determined based on the advice of a newly-established Low Pay Commission. The government has initiated sweeping changes in financial supervision and regulation aimed at creating a single regulatory organization with strengthened accountability.

Executive Board Assessment

They welcomed the authorities' determination to improve on an already impressive economic performance—with growth strong, unemployment declining, and inflation low—through policies aimed at reinforcing stability and long-term growth. In this regard, Directors commended the bold steps the authorities had already taken: a decisive front-loaded fiscal consolidation path; operational independence for the Bank of England; and the emphasis on transparency and accountability in government operations. Directors also welcomed the Chancellor's statement on Economic and Monetary Union issued earlier that day.

At the same time, Directors cautioned that the macroeconomic environment was challenging, due to the presence of divergent pressures. Surging domestic demand could accelerate further with the effects of consumer windfalls, while the tradable goods sector was likely to weaken under the lagged effects of sterling's appreciation over the past year. Most Directors saw risks on both sides in the current situation: on one side, with output now close to potential, too-rapid growth based on the momentum of domestic demand could rekindle inflation; on the other, the delayed contractionary impact of sterling's appreciation could precipitate a hard landing. Some Directors saw the balance of these risks as weighted toward the upside. In light of these risks, Directors welcomed the timely action that had been taken to alleviate them. In particular, they viewed the large front-loaded fiscal correction in the July 1997 budget as the right response. Some Directors felt, however, that the budget should have done more to dampen consumer spending. Directors stressed that firm implementation of the budget measures, especially through strict adherence to spending limits, would now be essential to build credibility and to set the public finances on a sound medium-term track.

A number of Directors noted the need to flesh out medium-term fiscal plans, including providing greater clarity on the government's fiscal goals. A few Directors noted that encouraging investment in physical and human capital had to go hand in hand with policies to boost national savings. Several Directors thought that these considerations favor a more ambitious medium-term fiscal objective, namely, balance over the cycle, rather than a "Golden Rule."

Directors supported tax reforms that would emphasize the strengthening of national saving as a key objective. While acknowledging the merit of some of the recent and planned measures in this context, they stressed the need for an integrated approach aimed at overall neutrality, given their concerns that a series of piecemeal reforms might end up increasing overall distortions. They agreed that an important element of such an approach would be to shift more of the burden of taxation from income toward consumption. In this regard, while noting that successive governments had foresworn significant broadening of the VAT base, most Directors clearly saw a case for serious economic debate on this issue, given the difficult choices that lie ahead in reconciling spending priorities.

Directors drew attention to the challenges of sustaining the expenditure reductions of recent years while meeting commitments to increase spending in priority areas, such as health, education, and public infrastructure investment. They noted the central role of the Comprehensive Spending Reviews, but observed that, for these reviews to be successful, the government would need to follow through on its intentions to contemplate radical changes in the state's role in the economy, particularly in areas such as social security.

Turning to monetary policy, the four successive monthly interest rate increases through August were seen by Directors as clear evidence of the monetary authorities' firm commitment to macroeconomic stability, while the current pause was seen as warranted to better gauge the momentum of the economy and the effects of interest rate hikes—as well as of the fiscal tightening introduced in the July budget. Directors supported the authorities' intention to remain vigilant and to stand ready to respond in a timely way to unfolding developments, especially if there were signs that growth was not decelerating in a manner consistent with achieving the inflation target.

Most Directors viewed the 2½ percent inflation target as appropriate in the present conjuncture, but some expressed the hope that the target would be lowered in the context of a more opportune cyclical situation. Directors welcomed steps to strengthen the Bank of England's accountability for achieving the inflation target, but some cautioned that the new arrangements for strict accountability should not be allowed to result in a lessened emphasis on the inherently forward-looking nature of inflation targeting. Given the lags with which policies took effect, some Directors recommended the explicit reincorporation of the time horizon of two years or so—in line with past practice.

Directors welcomed the authorities' commitment to preserving the flexibility of the United Kingdom's labor markets, as well as the initiatives to increase employability and the tax and benefits reform to strengthen work incentives. While supporting the greater emphasis on active labor market policies in the Welfare-to-Work program, they thought that successful implementation of that program in a short time span would be a considerable challenge. On the minimum wage, Directors warned that setting the rate at an overly high level would jeopardize employment while doing little to alleviate inequities. They urged the authorities to proceed very cautiously in setting the level of the minimum wage, and, in particular, to establish lower rates or exemptions for youths.

Directors welcomed the government's declaration of support in principle for participation in monetary union, subject to its meeting certain economic tests, particularly regarding cyclical convergence.

In other areas of policy, Directors welcomed plans to integrate financial oversight to focus accountability, and thereby strengthen supervision. Directors also welcomed the authorities' decision to reverse the decline in official development assistance.

Press Information Notices (PINs) are a new series of IMF press notices (see Press Release 97/21). PINs are issued, at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies.

United Kingdom: Selected Economic Indicators

	1994	1995	1996	1997 1/	1998 1/
Real Economy (change in percent)					
Real GDP	4.3	2.7	2.3	3.3	2.6
Domestic demand	3.4	1.8	2.7	3.8	3.0
CPI (excluding mortgage interest)	2.4	2.8	2.9	2.6	2.7
Unemployment rate (in percent)	9.3	8.2	7.5	5.8	5.0
Gross national saving 2/	15.9	16.3	16.1	15.8	15.5
Gross domestic investment 2/	15.5	16.1	15.8	16.2	16.7
Public Finance (in percent of GDP)					
General government balance	-6.9	-5.6	-4.7	-2.0	-0.6
Public sector borrowing requirement (PSBR) 3/	6.3	4.8	3.6	1.6	0.6
General government debt 3/	48.4	50.5	53.8	52.4	50.5
Money and Credit (end-year, percent change)					
MO	6.9	5.6	6.9	6.4 4/	...
M4	4.0	9.9	9.6	11.8 4/	...
Interest Rates (year average)					
Three-month Interbank rate	5.5	6.7	6.0	7.44 5/	...
Ten-year government bond yield	8.2	8.2	7.8	6.58 5/	...
Balance of Payments (in percent of GDP)					
Trade balance	-1.7	-1.6	-1.7	-1.8	-2.3
Current account	-0.2	-0.5	-0.1	-0.3	-1.0
Reserves (national valuation of gold, end of period, in billions of SDRs)	30.0	33.1	32.3	30.3	...
Fund Position (June 30, 1997)					
Holdings of currency (in percent of quota)				78.0	
Holdings of SDRs (in percent of allocation)				15.1	
Quota (in millions of SDRs)				7,414.6	
Exchange Rate					
Exchange rate regime			Floating exchange rate		
Present rate			US$1 = 0.6169		
Nominal effective rate (1990 = 100)	89.3	84.9	86.3	100.4	...
Real effective rate (1990 =100) 6/	90.8	86.9	90.1	108.9	...

1/ IMF staff projections, except where noted.
2/ In percent of GDP.
3/ Fiscal year beginning April 1; PSBR excludes privatization.
4/ July 1997.
5/ As of August 29, 1997.
6/ Based on relative normalized unit labor costs in manufacturing.