NOT FOR PUBLIC USE

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 87/31

10:00 a.m., February 24, 1987

M. Camdessus, Chairman
R. D. Erb, Deputy Managing Director

Executive Directors	Alternate Executive Directors
A. Abdallah	E. T. El Kogali
	Jiang H.
C. H. Dallara	M. K. Bush
A. Donoso	
	S. K. Fayyad, Temporary
G. Grosche	
J. E. Ismael	J. Reddy
A. Kafka	H. A. Arias
T. P. Lankester	
H. Lundstrom	
M. Massé	D. McCormack
Mawakani Samba	
Y. A. Nimatallah	
G. Ortiz	
H. Ploix	
G. A. Posthumus	J. de Beaufort Wijnholds
	I. Sliper, Temporary
G. Salehkhou	
A. K. Sengupta	
K. Yamazaki	
S. Zecchini	

L. Van Houtven, Secretary
S. L. Yeager, Assistant

Also Present

Asian Department: P. R. Narvekar, Director. European Department: L. A. Whittome, Counsellor and Director; P. B. de Fontenay, Deputy Director; B. E. Rose, Deputy Director; J.-P. Cotis, M. T. Hadjimichael, S. F. D. Powell, G. T. Saxerud, E. Spitaeller, H. Vittas. Exchange and Trade Relations Department: C. D. Finch, Counsellor and Director; W. A. Beveridge, Deputy Director; M. Guitián, Deputy Director; J. T. Boorman, J. M. T. Paljarvi. External Relations Department: C. S. Gardner, Deputy Director. Fiscal Affairs Department: A. A. Tait, Deputy Director; G. M. Bartoli. Legal Department: F. P. Gianviti, Director; A. O. Liuksila. Middle Eastern Department: S. M. Thakur. Research Department: J. A. Frenkel, Economic Counsellor and Director; A. D. Crockett, Deputy Director; W. M. Corden, M. D. Knight, F. Larsen. Secretary's Department: J. W. Lang, Jr., Deputy Secretary. Western Hemisphere Department: E. Wiesner, Director; S. T. Beza, Associate Director. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: P. E. Archibong, M. B. Chatah, L. P. Ebrill, G. D. Hodgson, K. Murakami, J.-C. Obame, G. Pineau, N. Toé, A. Vasudevan. Assistants to Executive Directors: A. R. Al-Abdullatif, H. Alaoui-Abdallaoui, J. R. N. Almeida, H. S. Binay, J. de la Herrán, F. Di Mauro, R. Fox, M. Hepp, A. Iljas, O. Isleifsson, A. R. Ismael, S. King, M. Lundsager, V. K. Malhotra, C. Noriega, J. K. Orleans-Lindsay, G. Schurr, G. Seyler, B. Tamami.

1. REPORT BY MANAGING DIRECTOR

The Chairman remarked that he had participated in the meeting of the Ministers and Central Bank Governors of the Group of Six, held in Paris on February 22, 1987. Much of what had taken place in Paris had been reported in the press; he would therefore limit his comments to some observations on the communiqué. 1/

The Ministers and Governors had focused on three issues, the Chairman continued. The first was multilateral surveillance based on key economic indicators, as set forth in the Tokyo Economic Declaration of May 1986. In that respect, three points mentioned in the communiqué--the additional refinements of the economic indicators, their relevance to the international economic strategy, and the consistency of present exchange rates with underlying fundamentals--were of particular interest to the Fund. During that part of the discussion, he had offered a few opening remarks and had answered questions on points relevant to the Fund.

In his remarks he had emphasized that the main concern of the Fund in the present circumstances was the sustainability of prospective balances of payments and the associated pattern of exchange rates, the Chairman added. A second concern was the level of economic activity, not only in the seven major industrial countries, but in the whole membership: the failure to ensure that important shifts in the balance of payments and fiscal policy efforts of the major industrial countries were well coordinated could adversely effect the global economy.

The discussion on surveillance was well supported by the Fund's recent work on indicators, the Chairman noted. Discussions had been more precise, and Ministers and Governors had shown more commitment to their multilateral surveillance strategy and to implementing the conclusions drawn from their common examination of the situation. An important fact, which was evident from paragraph 7 of the communiqué, was that all countries had problems in implementing certain economic policies in a coordinated manner, especially because of their respective political calendars. Nevertheless, the Group strongly supported the strategy of intensified economic policy coordination to promote more balanced global growth and reduce existing imbalances. Surplus countries were committed to follow policies designed to strengthen domestic demand and to reduce their external surpluses; deficit countries were committed to follow policies designed to encourage steady, low-inflationary growth while reducing their domestic imbalances and external deficits; and all countries had made long-range individual commitments. A careful examination of paragraph 7 revealed that some countries were committed to go beyond their previous national policy stance. In sum, the agreement on the strategy to be pursued was most welcome.

1/ The text of the communiqué of the Group of Six was issued as EBD/87/59 (2/24/87).

The Group had also agreed on additional refinements in the use of economic indicators in the multilateral surveillance arrangements, the Chairman commented. That agreement, set out in paragraph 9 of the communiqué, was particularly important to the Fund. The Fund's approach to the world economic outlook exercise should be inspired and encouraged by what was implicitly suggested in that paragraph. In particular, the Fund should broaden the indicator strategy horizon, by reinforcing and sharpening as much as possible its medium-term projections, and by making policy interactions among countries more evident so as to underline the possible emerging problems in a timely manner. The Group agreed that although such analysis would not lead to fine-tuning, it could result in a better mutual understanding of problems and in efforts to adapt national economic policies with a view to their global consequences.

He had been impressed by the tenor of the Group of Six meeting, the Chairman added. The use of agreed instruments for reviewing economic developments had facilitated the discussions, and Ministers and Governors had been able to focus directly on issues rather than debating statistical problems; that was an extremely important development.

Paragraph 10 of the communiqué on the consistency of the present set of exchange rates with underlying fundamentals had received much attention in the press, the Chairman observed. The final sentence, "In current circumstances, therefore, they agreed to cooperate closely to foster stability of exchange rates around current levels," had given rise to speculation on whether there had been a major agreement to stabilize exchange rates or some secret, private arrangements. A key to answering that question could be found in the declaration of one of the Ministers suggesting that a reading of previous communiqués of the Ministers and Central Bank Governors of the major industrial countries since September 1985 would help clarify the meaning of paragraph 10. In fact, what was noteworthy was that there was a commitment to cooperate to foster the stability of exchange rates at current levels, and that agreement was important in present circumstances. The Paris meeting was the first in a series of policy coordination exercises: it would be followed by the Board's discussion of the world economic outlook; the spring meeting of the Interim Committee; the economic summit in June; and the Annual Meetings in September. The Group considered that each of those meetings was a station on the road to closer coordination of economic policies. Indeed, the increasing use of the word "coordination" in the statements by the Group was in itself noteworthy; it clearly indicated that in the face of major growing difficulties in the world economy, the main industrial countries were agreed on the need for closer coordination and cooperation.

In conclusion, the Chairman remarked that the meeting had indeed marked a significant step in the development of the multilateral surveillance strategy and had been characterized by a high degree of mutual understanding and resolve for cooperation.

Mr. Nimatallah remarked that he was grateful to the Chairman for his comments on the Paris meeting. He also wished to convey through the Chairman the gratitude of his authorities to the Group; their exchange of views on exchange rate stability was very important, and the outcome of their meeting had exceeded his expectations. Such consultation was healthy, and it was encouraging to know that it would continue.

He hoped that the Chairman had conveyed to the Group the request made by Mr. de Groote, among other Directors, that ministers, like their heads of state, should meet regularly, either on an annual or semiannual basis, so as to avoid the sense of urgency and crisis that often accompanied their gatherings, Mr. Nimatallah added.

Finally, there were those who believed that ministers should not discuss exchange rate zones but rather the policies behind them, while others considered it necessary to agree on target zones first, and to tailor policies accordingly, Mr. Nimatallah observed. Both views were correct, in his judgment, depending upon the time frame. Two years previously, when exchange rates had been misaligned, it would have been helpful to concentrate on policies rather than on target zones; at present, however, exchange rate relationships were reasonable and should be stabilized, so that the use of target zones might be a step in the right direction. That did not mean that the pursuit and coordination of appropriate policies was not important; rather, emphasis should be placed, first, on keeping exchange rates within certain zones and, second, on pursuing policies that maintained rates within those zones.

Mr. Kafka remarked that he wished to express his satisfaction, and that of his colleagues, at the Chairman's report. The Chairman's regular and active participation in such meetings was also welcome.

Mr. Sengupta observed that paragraph 10 of the Group's communiqué asserted that "exchange rate changes since the Plaza Agreement will increasingly contribute to reducing external imbalances and have now brought their currencies within ranges broadly consistent with underlying economic fundamentals...." He wondered whether the Research Department could study that important assertion; in particular, was it correct? More important, what were the fundamentals; how were exchange rate ranges consistent with fundamentals; and what policies were relevant to them? The answers to those questions would have to be developed over time, but a preliminary examination of them could help contribute to Directors' understanding and to the development of policy tools in the future.

The Chairman remarked that he would be pleased to discuss the points raised by Mr. Sengupta, as well as any other comments and requests for information by Directors, on an informal basis, before the Executive Board considered them in a more formal context. In that regard, it was expected that the forthcoming world economic outlook exercise would reflect recent developments and multilateral undertakings.

The Deputy Managing Director then assumed the Chair.

2. UNITED KINGDOM - 1986 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1986 Article IV consultation with the United Kingdom (SM/87/25, 1/28/87; and Sup. 1, 2/20/87). They also had before them a background paper on recent economic developments in the United Kingdom (SM/87/32, 2/10/87; and Sup. 1, 2/12/87).

The Deputy Director of the European Department observed that paragraph 7 of the Group of Six communiqué, circulated to Directors earlier in the meeting, contained a description of the undertakings of the U.K. Government, which was relevant to the present discussion.

Mr. Lankester made the following statement:

I will comment briefly on recent developments in the U.K. economy and on the main policy issues highlighted in the staff report.

Overall, the outturn for 1986 has been quite favorable. A year ago I told the Board that we expected that growth would be toward the upper end of the 2 percent to 3 percent range. Slower activity in the early part of the year, which of course was not confined to the United Kingdom, has held back the year-on-year growth rate to about 2 1/2 percent. This is our latest estimate, though on past experience it could well be revised upward. Non-oil output, particularly in recent months, has been growing rather faster. This performance compares well with that of other industrial economies, and is further evidence of the United Kingdom's improved relative performance--which is well illustrated in Chart 1 of the report--during the present decade.

Annual inflation in the fourth quarter was 3 1/2 percent--somewhat higher than at midyear but exactly in line with the last budget forecast. Unemployment, though still high at just over 11 percent, has at last begun to drop. Public sector borrowing has been running well below the budget estimates despite lower than forecast oil revenues, indicating a somewhat tighter fiscal stance than earlier expected. And the current account, notwithstanding a $4 billion reduction in net oil exports, was more or less in balance.

As the staff indicate, the prospects are good for a seventh year of expansion in 1987--at roughly 3 percent over 1986. Against this background, and with inflation showing some signs of further edging up, the main immediate task of my authorities is to ensure that monetary conditions continue to put downward pressure on inflation.

As in previous years, our macroeconomic policies will continue to be set with a view to providing an adequate, but not excessive, growth of money demand. The precise mix of fiscal and monetary policies will be clearer following the revenue decisions to be announced in the budget on March 17. We have certainly noted the staff's suggestion that the fiscal target for 1987/88 should be more ambitious than that for 1986/87. Whether or not a more ambitious target is adopted, it is worth pointing out the substantial progress made in the past few years in reducing the public sector borrowing requirement (PSBR) as a share of GDP. As Chart 12 shows, this applies also when the PSBR is adjusted for asset sales and "nonpermanent" oil revenue. The PSBR is now at its lowest level in relation to GDP since the early 1970s, whether or not it is adjusted in these ways. The debt/GDP ratio has continued to decline.

We can understand the staff's disappointment at the increases in planned government expenditure, which were announced in November. But as was explained during the consultation, the increases are accounted for mainly by extra spending by the local authorities which, for a variety of reasons--including constitutional ones--the Government has found it difficult to prevent. Nonetheless, continuing efforts are being made to find ways of improving the control of this spending. In any event, we believe that the new planning totals for overall spending are now much more realistic. And they will still involve a continuing reduction in the ratio of spending to GDP.

As the staff indicate, the conduct of monetary policy has remained difficult. Because of continuing institutional and behavioral changes affecting the holding of financial assets, the various monetary indicators have been hard to interpret. In the circumstances, the authorities have had to operate policy in an an eclectic manner, albeit with the overall objective of maintaining downward pressure on inflation. This will continue to be the case. Nominal and real interest rates have been high by international standards; but this has been necessary in the face of the rapid expansion of credit to the private sector and of broad liquidity. By contrast, to have pushed interest rates still higher in order further to counteract the credit expansion would have produced excessively tight conditions. We are glad to note the staff's view that the direction of policy, taking into account the various uncertainties, has been broadly appropriate.

The exchange rate fell significantly in 1986, as was appropriate in response to the fall in oil prices. This should permit a shift of resources into the external sector to offset the decline in oil exports. But like the staff, we still expect the current account to move into deficit in 1987. In view of the huge buildup in overseas assets in recent years, this should not be a major cause for concern. However, we agree with the staff that it is important that U.K. competitiveness should not be eroded. Yet my authorities would have considerable reservations about trying to achieve this through active management of the exchange rate. This would all too easily have a destabilizing effect in financial markets and risk refueling inflation.

My authorities' longer-term task is to improve the efficiency of the economy. And this includes improvements in the labor market so as to bring more people into work.

The productivity trend continues to be favorable. In the three months to November, manufacturing output per capita was 4 1/2 percent higher than a year earlier. Over the period 1979 to the first half of 1986, output per capita in manufacturing grew at an average rate of 3 1/2 percent per year. This compares with an average of 2 1/2 percent for the Group of Seven countries.

We are now seeing the fruits of a major improvement in the efficiency and organization of production. This reflects many factors, especially a more competitive environment, a sharpening of incentives facing managers, and a general improvement in managerial performance.

But wages and salaries in the United Kingdom are still increasing too fast. This and other inflexibilities in the labor market continue to act as a brake on the creation of new jobs. The persistence of relatively large pay increases in the face of high unemployment is something of a puzzle, especially when there have already been a number of important reforms--notably the successive changes since 1980 in trade union law.

There are various explanations. First, it was always going to take time for economic agents to act more rationally in response to the changed labor environment. A second explanation, which is receiving increasing attention, is that the longer-term unemployed may not have a very significant impact on pay bargaining. Other explanations focus on possible reasons for the willingness of employees to pay higher wages to their existing employees even though there are unemployed people who are willing to work for less. For example, existing employees have special firm-specific skills that employers wish to retain, or employers are prepared to pay a premium to minimize turnover, given the costs involved in hiring and training new workers.

My authorities intend to persevere with a range of measures to improve efficiency in the broadest sense. Among the more important are training and retraining and helping the long-term unemployed find jobs; encouraging profit-related pay; encouraging regional pay variations to take account of the very different labor market situation in different regions; and carrying forward the highly successful privatization program. Another major reform which my authorities have actively encouraged is the deregulation of the financial markets. The so-called Big Bang in the City of London last October should facilitate the United Kingdom's continued role as a major net exporter of financial services.

Mr. Massé made the following statement:

The United Kingdom's medium-term policy thrust has produced encouraging results during the 1980s. Substantial success has been experienced in reducing inflation, in restoring generally satisfactory rates of economic growth, and in improving the efficiency of markets through a series of measures aimed at reducing regulation and government intervention and at promoting corporate tax reform. Furthermore, the public sector borrowing requirement has been steadily reduced. These are all significant accomplishments. We note as well that the staff and the authorities expect a continuation of growth in 1987 at the higher rate reached during the second half of 1986.

Nevertheless, within that favorable overall picture, there are still elements of concern, of which the continuing high rate of unemployment is the most serious, followed closely by weak domestic investment. On this second point, we note that consumer expenditure is expected to remain the mainstay of growth in 1987. While the rate of increase in investment is expected to rise this year, it remains relatively weak by historical standards and also when measured against the substantial improvement in profitability.

On monetary policy, my authorities appreciate the difficulties associated with interpreting the behavior of the main monetary aggregates. Changes in the financial system and special factors help to explain part of the rapid monetary expansion. However, in view of recent developments with respect to wages and prices, as well as indications of a continued rapid expansion of bank credit and the high degree of liquidity in the economy, I am somewhat more skeptical than the staff about the actual degree of monetary tightness at present. Even if one discounts the continued rapid growth of the broad aggregate M3, which has been influenced by factors such as financial innovation and sales of public assets, the question still arises whether the authorities should not be more concerned over the recent acceleration of the growth rate of narrow money. Moreover, it is not clear that the authorities can take much comfort from the present relatively high level of short-term interest rates, which might actually be an indication of anticipated higher inflation. While these observations may not lead to the conclusion that monetary policy should be tightened, they do support a view that there is little, if any, scope for relaxation of monetary conditions.

As for fiscal policy, it is our view that the medium-term strategy of strengthening the fiscal balance and reducing the Government's role in the economy should continue. It is now clear that the PSBR for fiscal year 1986/87 will be well below its target of £7 billion--as a result of the buoyancy of tax revenues--which provides the authorities with some room for maneuver regarding policies to be pursued during 1987/88. Indeed, if the use of liquidity by the public sector is as low as it was in the first four months of 1986/87, that room for maneuver may be large. I tend to agree with the staff that it is appropriate to use the PSBR adjusted for transitory items--namely, North Sea oil revenues and proceeds of sales of public sector assets--rather than the actual PSBR, to assess the degree of tightness of fiscal policy and progress made toward relevant medium-term objectives. Given that the adjusted PSBR has not fallen significantly since 1979/80, and since demand stimulus is not needed in the economy at present, the authorities should set a more ambitious fiscal target for 1987/88. A lower PSBR would boost confidence in financial markets, help underpin the pound, and thus potentially pave the way for lower interest rates. It would also help to dispell any doubts about the authorities' commitment to fight inflation.

To the extent that the more recent PSBR figures for 1986/87 are related to permanent revenue gains associated with changes in the corporate tax structure, room may exist to reduce the high marginal rate of income taxes. Such a move might have favorable supply-side implications for the economy, especially if emphasis is placed on reducing the high marginal rate of taxation on lower incomes, in view of the long-term unemployment problem.

On exchange rate policy, in view of the uncertain trend for oil prices in the coming years, it will be important for the United Kingdom to encourage improvements in the international competitiveness of non-oil industry. I share the staff's concern about allowing the exchange rate to appreciate, and support the staff recommendation that in the face of any pressure on the pound, emphasis should be placed on replenishing official reserves.

I have greater doubts, however, that further depreciation in the effective exchange rate of the pound might be useful in maintaining equilibrium in the current account over the medium term. Such a strategy, which involves a declining exchange rate to facilitate current trends in wages and price movements relative to the United Kingdom's trading partners, could lead to an unstable situation. The real effective exchange rate has already depreciated by an estimated 10 percent during 1986, and by an even greater amount vis-à-vis currencies other than the U.S. dollar. While the real depreciation during the past year may prove effective in strengthening the non-oil external current position, partly because the fall in international energy and commodity prices has dampened the overall inflation rate, there is now a danger that further depreciation might quickly be reflected in increased prices. To avoid a resurgence of inflation, there is a need to stabilize the pound, whether within the exchange rate mechanism of the European Monetary System (EMS) or otherwise. Further improvements in competitiveness therefore should be sought through structural measures that moderate the increase in unit labor costs, rather than through excessive reliance upon the exchange rate.

Labor markets and the unemployment rate are an overriding concern. The underlying growth rate of nominal earnings of about 7 1/2 percent, combined with the apparent slack in the labor market, is indeed a puzzle, which in many respects defies conventional analysis of labor markets. The puzzle raises two questions. First, is there indeed an absence of slack in the labor market, despite an unemployment rate in excess of 11 percent? And second, are there other factors that might explain the continuing rise in real wages?

Regarding the first question, the staff report and Appendix V of the supplement to the background paper suggest that there may not be much slack in the labor market. Part of the answer to the puzzle may lie in a segmentation of labor markets. Long spells of unemployment may have resulted in an erosion of some workers' skills, and also in an erosion of incentives to re-enter the labor market, resulting in a schism between employed workers and the unemployed, and a consequent upward shift in the natural rate of unemployment. This line of argumentation is interesting and has implications for stabilization policy, because it suggests that the natural rate is a function of the actual rate of unemployment. Therefore, demand compression policies to reduce inflation may produce undesired, long-term increases in the level of unemployment.

Other factors, particularly the relative immobility of British labor, also may help to explain the persistence of high rates of unemployment. An article in the February 7, 1987 issue of The Economist, citing a recent OECD study, suggests that Americans are three times as likely to move between regions as Britons or Germans and are also 50 percent more likely to change jobs. These figures suggest that barriers to mobility, in all forms, need to be addressed if unemployment in the United Kingdom is to be reduced.

As for the second question, apparent wage stickiness in the United Kingdom might be related to a combination of factors, including improved business profitability, productivity increases, continuing inflationary expectations, and a desire for industrial peace in a period of continuing growth. Employers may be prepared, in profitable times, to buy labor peace through wage settlements that are higher than necessary, while maintaining roughly the same production functions and capital-labor ratios.

What policy implications can be drawn from all of this? First, demand stimulation is unlikely to produce any significant reduction in the rate of unemployment. Rather, the authorities will need to use every means at their disposal to improve labor market mobility and wage flexibility. These measures might include encouragement of profit-sharing schemes, part-time work and job-sharing, and decentralization of wage bargaining. The interviews under the "Restart" program are one useful idea. The authorities also might try to encourage greater regional wage differentiation to reflect the relative economic strength of regions, and might contemplate measures to expand the rental housing market, such as easing of rent controls, so as to improve the physical mobility of labor. Lastly, the authorities must maintain a consistent anti-inflationary posture in macroeconomic policy, since the costs of squeezing inflation out of the system may be much greater than had been previously thought.

Finally, I would like to acknowledge the authorities' efforts to maintain an open world trading system. I would urge them to work within the European Community for a rollback of trade barriers, particularly subsidies to production and export of agricultural products, so that world agricultural trade can again proceed on the basis of comparative advantage.

Mrs. Ploix made the following statement:

It is always difficult to come to a clear judgment on the United Kingdom's economic situation. Overall, recent developments are favorable, since the United Kingdom's general performance compares well with that of other major industrial countries. However, widespread structural rigidities and the long-term decline in international non-oil trade are a source of concern for the future. As regards the 1986 economic performance, two encouraging elements should be emphasized--the sustained growth rate, and the long-awaited stabilization of unemployment. By contrast, it is somewhat disquieting that domestic consumption is the main factor behind these developments. In view of the high level of domestic demand, one can reasonably wonder whether present economic growth exceeds productive potential. Such an interpretation would be consistent with the renewal of inflationary pressures and with the ongoing weakening of the external position. In this context, fiscal policy appears to be particularly important; any relaxation would obviously pose a serious threat to the stability of future developments.

Table 2 of the staff report shows that the upturn in aggregate demand has its origin in private consumption, which results in turn from a strong rise in household disposable income. This development is mainly attributable to a substantial increase in real wages, which appears out of line with the trend in the major industrial countries. In this respect, Chart 4 of the report is illuminating. We understand the authorities' reluctance to intervene directly in the wage bargaining process for the sake of their deregulating approach; nevertheless, it is incumbent upon them to provide guidance through their pay policy in the public sector, notwithstanding the various constraints they face. In this respect, exceptional wage increases granted on the basis of real changes in work practices should not become the norm for wage bargaining.

On the supply side, various indicators are cause for concern. The upward trend in vacancies implies the unavailability of skilled workers; more fundamentally, the historically high rate of capacity utilization and the sharp decrease in the number of firms operating at below-normal capacity suggest that general strains might appear. Moreover, the reference to 1979 levels is not fully convincing in view of the slow investment growth in the private sector in recent years and, consequently, some probable obsolescence of equipment.

As for monetary policy, we are following with great interest the way the U.K. authorities are operating in such confused circumstances. Their objective of maintaining downward pressure on inflation is all the more well-founded because inflationary expectations are reappearing, and because the buildup of substantial real monetary assets could threaten monetary control in the future.

With respect to the exchange value of the pound sterling, the serious weakening of the current account, which was slightly negative last year for the first time since 1979, is noteworthy. Again, the decline in oil prices provides part of the explanation, but the deep deterioration of the external position is not fully explained by this factor. In fact, since the beginning of the 1980s the non-oil trade deficit has widened continuously; this adverse trend has not been reversed by the depreciation of the pound. To restore the international competitiveness of the U.K. economy, efforts should be oriented primarily toward controlling domestic costs.

In 1986, the rising trend in the unemployment rate was checked. The authorities should be commended for this achievement, which is largely due to the sustained implementation of various special schemes. These favorable results should encourage the authorities to follow the same course of action while avoiding any inflationary measures and any counterproductive tax on wages that would place a burden on labor costs.

Probably the most debated issue in U.K. economic policy at present is adjustment in the public sector. In general, the awareness of the need for adjustment spreads slowly among the public entities. Some institutional or local factors are often likely to weaken the commitment to adjustment, and it is sometimes difficult to convince all parties to comply with the PSBR target. Nevertheless, it is essential that the U.K. authorities not depart from their medium-term program of fiscal consolidation, because further demand stimulation may lead to a risk of renewed inflation. According to Mr. Lankester, the expenditure increases announced in November were an acknowledgment of past events which "the Government has found difficult to prevent." Any further slippage on the expenditure side would be deeply worrisome. Therefore, we welcome the authorities' policy commitments as reiterated in the communiqué following the recent meeting of the Group of Six.

Mr. Ismaël made the following statement:

With one exception, to which I will refer later, I can broadly support the staff appraisal. Economic developments in 1986 were broadly satisfactory. A steady rate of economic growth has been maintained, and inflation has been kept under control. The only area where economic performance was not satisfactory is unemployment, which is indeed a difficult problem to tackle in the United Kingdom, as it is in many other countries.

The stance of economic policies in the United Kingdom, with the exception of monetary policy, is broadly appropriate, although there is room for improvement in several areas.

In the fiscal area, considerable progress has been made in reducing the public sector borrowing requirement from 3.3 percent of GDP in 1981/82 to 1.6 percent of GDP in 1985/86. However, if these figures are adjusted for receipts associated with oil and privatization, the deficit amounts to roughly 5 percent of GDP, which could hardly be viewed as appropriate from a long-term point of view. I therefore agree with the staff that it is important for the authorities to make serious attempts to lower the budget deficit so as to reassure financial markets, relieve pressures on interest rates, and help sustain investment activity. I also agree that a somewhat more ambitious deficit reduction target should be pursued in 1986/87, in view of the strong revenue performance arising from buoyant private consumption and surging imports.

As for whether supply-side considerations would justify a reduction in the tax rates at this time, I do not believe that conditions are right for such tax reductions, although I have no doubt that, given the high tax rates in the United Kingdom, a reduction would have a positive effect on incentives. I urge the authorities to make greater progress with expenditure control in order to establish appropriate conditions leading to tax reductions at a later stage.

I fully appreciate the difficulties in conducting monetary policy in a rapidly changing environment. However, I do not accept the view that developments in the traditional monetary aggregates should be ignored altogether, especially when the magnitude of changes in these aggregates are too large. Moreover, I have considerable reservations regarding the staff's view that the overall direction of monetary policy is broadly appropriate. In recent months, money supply--both M1 and M3--has been rising at an annual rate of about 20 percent, which is excessive even after allowing for the effects of financial innovations. Indeed, some evidence suggests that the economy might be overheating. Economic growth in recent months has been strong, with industrial production rising at an annual rate of about 3 percent. Retail sales have been rising at a rate of 11 percent, wages have been rising at a rate of about 7 percent, and the annual inflation rate has now accelerated to 6.0 percent. The growth in domestic credit has been strong, which suggests that consumer spending will continue to rise rapidly. In addition, there are reports that many firms are facing difficulties in recruiting skilled workers needed to meet new orders. These indicators, combined particularly with rising inflation and deteriorating trade and current account positions, indicate that monetary policy may indeed be too expansionary and needs to be brought under control.

With respect to the labor market, a major concern is the authorities' lack of success in reducing unemployment. I fully share the staff view that stimulating domestic demand will not succeed in reducing unemployment, and indeed it could prove counterproductive. The authorities' efforts at reducing unemployment through measures to improve the functioning of the labor market, through manpower training, employment schemes, and other initiatives are in the right direction; and I encourage the authorities to persevere with them. The Government can also play a more direct role in reducing unemployment, for example, through a tighter control over public sector pay. In addition, the United Kingdom currently has a liberal unemployment benefit system, and the introduction of a somewhat stricter system could help reduce unemployment.

Regarding the timing of this discussion, I understand that the U.K. budget will be presented around mid-March, and I would have preferred that the discussion take place immediately thereafter, so that we could have a clearer picture of the policy intentions and actions of the Government. I hope that we would be able to do this in the future as a means of improving the effectiveness of Fund surveillance. On this occasion, I would like to request that the staff circulate a short note on the budget when the information becomes available. 1/

Mr. Kafka made the following statement:

We are in general agreement with the staff's analysis and appraisal, and also with Mr. Lankester.

Three aspects of the success of the United Kingdom's recent policies should be emphasized: growth in output compared well with that of other industrial countries; growth in productivity has been significant; and inflation has been brought down substantially from the early 1980s, even though it has started to exceed that of other Group of Five countries since 1983. To these favorable aspects there could be added the maintenance of a balanced current account in 1986, despite a radical decline in the oil trade balance.

Our concerns, like those of the staff and the authorities, relate to the high growth rate of wages, compared with other Group of Five countries, in the face of a high and, until very recently, rising rate of unemployment in relation to the total labor force. I am inclined to agree that this is not a problem which, under present conditions, is likely to yield to a social pact or an incomes policy. Nor would one expect an expansion of demand, even via exchange rate management, to be the appropriate policy. Yet it must be noted that the persistence for years of extraordinarily high unemployment rates must discourage people from pursuing the quest for work. The removal from the unemployment rolls of people in that situation is, obviously, not by itself a satisfactory solution. Certainly, however, the attempt to deal with the problem by structural measures addressed to the functioning, in the widest sense of the term, of the labor market must be encouraged. I find interesting the encouragement of profit sharing through tax incentives--I have, as a layman, always found particularly worthy of emulation the practice of large Japanese firms of paying a substantial part of workers' remuneration in the form of bonuses. To be effective, the U.K. tax incentives will perhaps have to be increased. Obviously, other incentives to pursue work wherever it can be found will also be necessary, and housing policy as well as rent control, comes to mind in this connection.

As for budgetary policy, progress has been made not only in bringing down the adjusted PSBR but has begun to be made also in respect of public expenditure as a share of GDP, after the

---

1/ A staff paper on the 1987 budget was circulated to Executive Directors as SM/87/85 on April 6, 1987.

uninterrupted rise of expenditure to 1984. Anybody familiar with the practical problem of government will sympathize with the U.K. authorities' difficulties in controlling the expenditures of local authorities. Nevertheless, it is highly regrettable that, and perhaps questionable whether, plans to reduce the direct tax burden cannot adequately prosper under these conditions.

Regarding monetary policy, we share some of the doubts expressed by Mr. Ismael. We appreciate the interesting differentiation made by the staff between real interest rates calculated by deflating with price indices and those reflecting unit labor costs. But we are not convinced that the latter are as significant as the staff seem to believe. Those observations cannot, obviously, reduce our concern regarding the level, compared with the structure, of investment.

Overall, the authorities' macroeconomic stance is roughly correct. In the circumstances, their emphasis on controlling inflation can be justified; but it cannot be justified to exactly the same extent for those Group of Five countries that are much farther advanced on the path of disinflation.

We are encouraged by the United Kingdom's commitment to an open trading system. The authorities could and should use their influence in the European Community to promote a rollback of protectionist initiatives, including the end of subsidies to production and exports of farm products. Furthermore, despite budgetary constraints, the United Kingdom should raise its official development assistance, which, at 0.34 percent of GDP, is marginally below the Development Assistance Committee average and less than one half of the well-established UN target of 0.7 percent of GDP.

Mr. Sliper made the following statement:

In examining the economic performance of the United Kingdom over this decade one is impressed by the huge strides that have been made. In the early 1980s the trends were somewhat frightening, with inflation rates running at about 20 percent, negative growth rates, and increasing government expenditure in real terms. These trends have all been substantially reversed, and further gains were made in 1986. The inflation rate has come down to 3 1/2 percent. The rate of growth, at about 2 1/2 percent, has been more modest than originally expected but appears reasonable in view of the decline in growth rates of other industrial countries. Similarly, the external accounts are in good shape and unemployment has leveled off.

The staff forecast of a growth rate for 1987 of about 2 3/4 percent seems to agree with many of the private forecasts in the United Kingdom. It is also expected that growth in 1987 will be more broadly based than in 1986, with positive contributions from the external sector and from investment, as well as continued strong growth in private demand.

There are of course some weaker areas of economic management, and I agree with the staff and the authorities that a more efficient functioning of the labor market should remain the foremost policy priority. In this connection, the supplement to the background paper, which provides useful insights into some of the particular problem areas of the U.K. economy, including the labor market, is welcome.

On the overall balance of policies, I concur with the authorities' judgment that it would be inappropriate at the present time to expand demand in order to reduce unemployment. Emphasis should continue to be placed on prudent fiscal policies and on supply-side measures to lessen some of the labor market rigidities.

With regard to fiscal policies, I had some reservation as to the government announcement in November 1986 of policies to increase public expenditure both for 1986/87 and beyond. This seemed to mark a reversal of the rigorous restraining measures that had been put in place in the preceding 4-5 years. Despite this expenditure expansion, the most recent figures suggest that the 1986/87 deficit position may be somewhat better than originally expected owing to higher tax receipts. Although some of this revenue increase is temporary, a portion is expected to be more permanent in nature. We hope that the authorities will not use those permanent proceeds to expand expenditures but will instead utilize some of the gains to decrease the PSBR. As to the PSBR, I agree with the staff that the appropriate borrowing requirement concept should exclude the proceeds from privatization and nonpermanent oil revenues. On that basis, the current PSBR is about 3 1/2 percent of GDP, which is still fairly high. A further reduction should induce a significant confidence effect and, consequently, give rise to sustained reductions in interest rates. Current real rates are, of course, high relative to those in other major financial markets.

Regarding monetary policy, it is easy to understand the difficulties facing the authorities in monitoring developments. In the United Kingdom, as in many industrial economies, there have been many changes in the monetary aggregates and hence difficulties in interpreting trends. Although the increased emphasis on narrow money is understandable, I generally support the view expressed by Mr. Massé and other Directors that the recent growth in narrow money and the continued high growth of broad money suggest that monetary policy is not especially tight at the present time.

As to labor market policies, I agree with the staff that progress in this area has remained slow. The comparisons shown in Chart 4 of the staff report of real wages and unit labor costs in the United Kingdom with those in other Group of Five countries are disturbing. They highlight the large real wage increases in the last year. Moreover, the recent increase granted to teachers foreshadows some major problems in setting public sector wages, in view of the existence of rather fixed relativities in the United Kingdom. Mr. Lankester has acknowledged that wages are increasing too fast and has offered some interesting explanations of possible causes.

During the 1985 Article IV consultation with the United Kingdom, we were critical of the staff view that suggested that employment subsidies were cost effective and could contribute to greater wage flexibility. We are pleased that no such conclusion has been put forward in this year's report. In fact, the whole thrust of the staff report is that wages will not be restrained and unemployment reduced unless a broad range of structural changes are fully implemented, such as introducing more profit sharing into wage fixing; establishing better control over local authority spending; improving labor mobility by removing rent controls; and encouraging different wage settlements by regions.

Press reports of a recent speech by the Minister of Employment suggest that the Government is intent on moving ahead in this area, including a proposal to get away from the whole concept of the national pay round. According to reports, the Minister said that the United Kingdom should work toward a system where pay increases are based primarily on performance, merit, company profitability, and demand and supply in the local labor market.

This commitment is encouraging because the authorities' resolve in tackling some labor market issues was not clear in the staff report. Certainly the report leaves the impression that the key reason for the authorities' announcement last year that the United Kingdom would not join the European Monetary System was doubts about the ability of the system to deliver moderate wage rises. The wage record of the last 12 months or so suggests that these doubts have been well founded.

My Australian authorities have commented that the U.K. position on trade is deserving of particular commendation. Although the agricultural sector has benefited from the Common Agricultural Policy to the point of becoming a major exporter of cereals-which highlights the economic folly of the Common Agricultural Policy--the United Kingdom obviously recognizes that such benefits are illusory. It is unfortunate that other EC members will not acknowledge the global--and generally domestic--benefits of freer trade in agricultural products.

In sum, in 1986 steady progress was once again recorded in most areas of economic management. The most troublesome areas are rising real wages and structural rigidities in employment. These problems are shared by most industrial countries. The authorities have introduced reforms in these areas, but it is clear that more broad-ranging changes are required if labor markets are to function more efficiently.

Mr. Grosche made the following statement:

I share Mr. Lankester's view that "in overall terms, the outturn for 1986 has been quite favorable." The numerous achievements have been clearly described in the staff papers and in Mr. Lankester's concise statement. The recovery, now in its seventh year, has continued at an underlying rate of about 3 percent, and inflation has come down from high levels. Productivity gains continue to be fairly substantial. The role of the public sector in commercial activities has been further reduced, and public sector borrowing this year is running well below estimates. Instead of dwelling on these commendable accomplishments, let me instead concentrate my remarks on those areas where policymakers continue to face challenges and hard decisions.

First, in the area of unemployment and wage policy, improvements are difficult to achieve and will take time. Like Mr. Lankester, I am somewhat puzzled about the persistence of large pay increases. Although the authorities have introduced important reforms, wages and salaries in the United Kingdom are still on the fast track. The employed are making real wage gains, obviously at the expense of the unemployed, as can be seen from the figures on productivity growth and laborshedding. Mr. Lankester offers a number of pertinent explanations for this situation. I am convinced that his authorities have embarked on the right track with their intention to improve further efficiency in the broadest sense. The measures described by Mr. Lankester are welcome, particularly training and retraining, encouraging profit-related pay and, not least, the privatization program.

The second challenge is the conduct of monetary policy, which poses some problems. Although for many reasons it has become increasingly difficult to interpret the behavior of M3, I nonetheless share some of the doubts expressed by Mr. Ismael. I am also a bit skeptical about the decision to do away with targeting in favor of an "eclectic" approach to monetary policy. With ample liquidity and prices again on an upward trend, monetary policy faces some considerable challenges ahead. It is certainly reassuring to read in the Paris communiqué of the Group of Six that the U.K. authorities will "ensure that monetary conditions continue to put downward pressure on inflation." In this context, I believe that targeting still can provide a strong backbone to policymakers.

Therefore, I am interested in the outcome of the discussion under way on whether broad money targets should be retained or whether a new target range should be presented at the time of the next budget.

A third challenge is exchange rate policy. Assessment of the appropriate level of the exchange rate is a difficult and often delicate matter, even if it is momentarily made easier by the Paris undertakings. From a purely macroeconomic point of view, a reduction in the degree of volatility of the pound would certainly be helpful for private sector decision making and for the setting of economic policy in general. To be sure, greater exchange rate stability would mean that competitiveness would have to be maintained through better control of domestic costs. In this context the well-known question arises whether the United Kingdom should participate in the exchange rate mechanism of the EMS. As we know from the staff paper and previous discussions, there is no easy answer to this question. I believe, however, that participation in the exchange rate mechanism of the EMS tends to enhance the credibility of anti-inflation and non-accommodation policies. It would also give some rough guidance to the conduct of monetary policy and could help to reduce volatility in financial markets.

With regard to fiscal policy, I join the staff in commending the authorities for keeping the PSBR target for the current fiscal year unchanged, despite the fall in oil revenue. As Mr. Lankester notes, borrowing in the current year has been running well below the budget estimates. Nonetheless, the fall in oil revenues has increased tensions in the budget, and it has become even more difficult than before to reach a compromise between the objectives of cutting taxes and reducing the deficit. I share the staff's recommendation for a more ambitious deficit target for 1987/88, and their disappointment at the increases in planned government expenditures. While I noted from the Group of Six communiqué and Mr. Lankester's statement that the new U.K. planning totals for overall spending will still involve a continuing reduction in the ratio of spending to GNP, I noted also from Table 6 of the staff report that the PSPR will remain virtually unchanged over the next three fiscal years. To be sure, higher oil prices and the better than expected revenue performance should help to reduce the PSBR substantially further. In this context, I would support a proposal made by the Bank of England to use permanent increases in revenues for tax cuts and cyclical improvements for deficit reductions.

In sum, we continue to support wholeheartedly the medium-term strategy that the United Kingdom has embarked on since 1979. Considerable progress has been achieved in many areas, and the authorities deserve our full respect. But substantial problems remain. I am confident, however, and reassured by

Mr. Lankester's statement, that his authorities are fully aware of the challenges they are still facing and are resolved to deal with them in their usual determined manner.

Mr. Ortiz made the following statement:

There have been no dramatic changes or surprises in the behavior of the U.K. economy during 1986. The Medium-Term Financial Strategy (MTFS) continues to be the basic framework for policy design, and it appears that the main guidelines have been effectively followed and that performance is not far from targets, as confirmed by Mr. Lankester.

We welcome the recent positive developments, especially the recovery in economic activity toward the end of 1986, and the results of the January 1987 Survey of Industrial Trends, which suggest increased business confidence and improved export performance. The prospects for a continued economic expansion of about 3 percent during 1987 are encouraging. The decline in unemployment since the second half of 1986, which apparently reflects the initial success of the Government's employment schemes, is particularly welcome. Does this decline reflect the removal from unemployment rolls of those people who do not respond to interview invitations under the recent Restart program, or have the recently implemented employment schemes actually resulted in putting people back to work? According to a recent article in The Economist, there have been 18 changes in the U.K. accounting procedures for measuring unemployment, 17 of which have had the effect of reducing the count; for example, the so-called "special employment measures" and other statistical changes have diminished the unemployment count by roughly 1 million people, equivalent to about one third of the officially unemployed. In any case, the problem of unemployment still looms as the most negative legacy of policies implemented earlier in the decade.

Despite some doubts on the appropriateness of the PSBR as the main fiscal indicator for the United Kingdom--in view of the transitory nature of the income from privatization and, possibly, from North Sea oil revenues--the authorities are still measuring the fiscal effort in terms of this indicator. Mr. Lankester had referred to Chart 12 of the staff report, which depicts the behavior of the PSBR since 1979, to point out that "substantial progress has been made in the past few years in reducing the PSBR/GDP ratio." While it is obvious that there has been a reduction, applying the concept of "adjusted PSBR" results in a reduction of less than 2 percentage points of GDP since 1979.

Whether there is additional room for tax cuts is always a controversial subject on which it is difficult to reach agreement. For the United Kingdom, a key consideration in this regard is the need to contain public expenditure. Thus far, the progress made in containing public expenditure has been limited: according to Appendix III of the supplement to the background paper, "Developments in public sector spending in recent years fell short of the Government's expenditure plans, which aimed at maintaining the public expenditure planning total broadly unchanged in real terms." In fact, general government expenditures increased from 43.3 percent of GDP in 1979/80 to almost 47 percent in 1982/83 before falling to 44 percent in 1985/86. The problem of controlling local authorities' outlays seems particularly serious, and the Government is preparing major reforms in this area. However, these measures will be introduced only gradually--because, I assume, of delicate political considerations--and therefore a judgment on their effects will not be possible before the beginning of the next decade. The authorities' fiscal effort illustrates the difficulties involved in exercising fiscal austerity in general, and of reducing fiscal expenditures in particular, even for a Government clearly committed--from a political and intellectual viewpoint--to these principles.

Regarding the conduct of monetary policy, I would only note the concerns expressed regarding the difficulties encountered in choosing a reliable monetary aggregate to gauge the stance of financial policies. The United Kingdom has been testing initiatives in monetary management for some time, and the difficulties that are currently being experienced are common to a number of industrial countries. As Mr. Lankester notes, "the authorities have had to operate policy in an eclectic manner"--much like everywhere else. He also notes that in the staff's view, the direction of monetary policy has been broadly appropriate.

The uncertainties and problems associated with the interpretation of monetary aggregates in a number of countries have had at least one positive effect: they have, in a way, "freed" central banks and financial authorities from strict monetarist straitjackets and recipes. Had monetary policy been managed earlier in this "eclectic" manner, it may have been possible to mitigate the deep recession suffered at the beginning of this decade, which had unfortunate and lasting consequences on the employment structure. One of the difficulties, however, has been to convince the public that the authorities remain committed to keeping inflation under control in the face of the divergent--and difficult to explain--behavior of monetary aggregates.

As for the external sector, the sharp drop in oil prices has affected substantially the U.K. trade balance, although various tables in the staff papers indicate that the deterioration in the visible trade balance has also been accompanied by a larger deficit on the non-oil tradable sector. The debate over the response of the sterling exchange rate to the evolution in oil prices has been of particular interest, as well as the coexistence of different streams of thought against or in favor of participation in the exchange rate mechanism of the EMS.

The staff refers to a rule of thumb that suggests that a drop in oil prices should be followed by a fall in the effective exchange rate equivalent to about one third of the original oil price drop. According to available data, a 55 percent drop in oil prices was accompanied by a 17 percent depreciation of the pound, which roughly matches the proportion suggested by the staff's simulations on the combinations of oil prices and exchange rates that would maintain the current account balance unchanged.

However, the authorities do not have an exchange rate target, and they are more ready to react to changes in the speed at which the pound depreciates. Regarding the conflicting assignments to exchange rate policy of domestic and external objectives, the authorities have apparently given more weight to the former. The focus of exchange rate policy has thus contributed to introducing wide fluctuations in the exchange rate. It seems clear, therefore, that the exchange rate as a policy instrument will continue to be aimed at maintaining domestic stability, playing the role of a monetary indicator, possibly at the expense--at least in the short run--of external objectives of improving competitiveness.

With respect to the labor market, in Appendix V of the supplement to the background paper, the staff mentions that "one of the great puzzles of the U.K. economy is why wage inflation remains high despite the unprecedented levels of unemployment and the favorable movement of some of the structural determinants of the natural rate of unemployment." The analysis contained in this Appendix, which reports on recent hypotheses and findings regarding this phenomenon is certainly useful. So-called hysteresis--the labor market segmentation resulting from the structural damage to the supply of labor owing to extended periods of unemployment--may well be at the root of the explanation of the puzzle.

The policy implications are clear. The inflation/unemployment tradeoff has become steeper, which implies that the problem of unemployment will probably not be resolved exclusively by demand-oriented policies. Since the nonaccelerating inflation rate of unemployment (NAIRU) is itself a function of the unemployment rate, job preservation ought to be at the top of the priority list when the time comes to adjust to the next downturn of the business cycle.

Finally, I would like to endorse Mr. Massé's comments regarding the United Kingdom's commitment to a free trade system and his exhortation to the authorities to continue pressing in this direction in the EC.

Mr. Yamazaki made the following statement:

In view of the many serious difficulties confronting the U.K. economy in the late 1970s, the significant achievements in economic performance in recent years are striking. These achievements were made possible by the Government's severe restraint policies, implemented in a most uncompromising and determined manner, which is indeed praiseworthy.

In 1986 the United Kingdom entered its sixth year of uninterrupted growth, achieving a rate of growth above 2 percent in spite of a sharp fall in oil prices. At the same time, the rate of inflation declined significantly. This favorable economic performance was brought about in the context of a medium-term financial strategy aimed at reducing inflation through a deceleration in monetary growth and a reduction in the public sector borrowing requirement. Economic activity picked up, particularly in the latter half of the year, supported by a rapid increase in consumer spending. Signs of improvement in employment have already emerged, and business investment is also expected to increase in response to the higher rate of capacity utilization.

These positive general developments notwithstanding, in some areas the expected improvement has not materialized, or signs of deterioration have emerged.

In the area of prices, the declining trend in the rate of inflation was reversed in late 1986; the inflation rate is now higher than that of other major industrial countries and is expected to accelerate in 1987. This price performance is rather disappointing, particularly when one recalls that the primary objectives of the Medium-Term Financial Strategy were a reduction in inflationary expectations and a recovery in business confidence, both of which were to be obtained through a continuous reduction in the real rate of inflation. In the context of the U.K. economy, price stability is also important to forestall excessive pay increases, which could trigger a wage-price spiral. In this connection, some of the relatively large pay increases in recent months are somewhat puzzling.

Unemployment remains the most intractable economic problem, with the rate of unemployment at close to 12 percent, although the upward trend appears to have been arrested. With economic expansion now under way, and in light of the recent sharp increase in job vacancies, the unemployment rate is expected to decline somewhat in the course of 1987. For a lasting decline, however, it is important to restrain the increase in real wages. The authorities do not favor an incomes policy, since it would be inconsistent with their goals of deregulating the private sector, and I can basically support this policy stance. It is therefore all the more important that the authorities maintain an appropriate macroeconomic framework conducive to a moderation in wage claims. At present, such factors as favorable business profits, high job vacancies, and the prospect for a rise in the rate of inflation point to the risk of higher wage settlements; any additional policy measure that would provide a further stimulus to the economy should be weighed against this risk.

It is also important to persevere with the structural reform of the labor market. Encouragement of the profit-sharing system and provision of training programs are steps in the right direction. The introduction of the "Restart" program, which calls for the systematic interviewing of all long-term unemployed and impose the penalty of forfeiting unemployment benefits for those who do not respond, is a bold step, and demonstrates the authorities' strong determination in this matter. The "Replacement ratio" has been reduced significantly, but a review of the present level may be warranted to establish whether its further reduction would contribute to a substantial improvement in the unemployment situation.

Private fixed investment holds the key to future growth, and it is disappointing that business investment was subdued in 1986. The phasing out of the capital allowance was a factor behind the lack of buoyancy, and the high real rate of interest may also have deterred capital spending. The same high interest rate, however, did not impede the rapid growth of consumer credit, which played an important role in supporting the high level of consumer spending. While business investment is expected to pick up in the course of 1987, as the rate of capacity utilization goes up, further policy measures, in addition to cyclical factors, may be called for in order to sustain the level of investment over the medium term. In this connection, it may be instructive to examine, in depth, why at a time when real interest rates were high, demand for consumer credit expanded so rapidly in 1986 while credit demand for business investment failed to pick up.

As for the balance of payments, while a sharp drop in oil prices aggravates the current account balance of oil producing countries like the United Kingdom, a sharp increase in the U.K. non-oil trade deficit in 1986 is a source of concern. A further rise in the non-oil deficit is likely in 1987, owing to an expansion of non-oil imports. I do not believe that the expected deterioration should have a destabilizing effect on the exchange rate, given the cyclical factor behind it and the increased importance of monetary factors in the determination of exchange rates. However, a deterioration in the current account balance for an extended period might be a sign of weakened fundamentals, and could trigger a spiral of exchange rate depreciation and price increases. This consideration argues for a cautious approach to an emerging current account deficit.

This brief examination of inflation, employment, investment, and the balance of payments makes it clear that strong adherence to the Medium-Term Financial Strategy, avoidance of overheating of the economy, and perseverence with structural reform are needed to achieve sustainable growth without inflation over the medium term.

On fiscal policy, I am pleased to note that the public sector borrowing requirement, adjusted for asset sales and nonpermanent oil revenue, has declined from close to 5 percent in 1985/86 to 3.6 percent in 1986/87 and is projected to decline further in the coming fiscal year. However, the staff report clearly shows that in order to stabilize the ratio of public debt to GDP--given the potential output growth rate at about 2 percent--the PSBR cannot exceed 1 percent of GDP. The gap between that target and the actual ratio achieved so far indicates the need for further efforts toward reducing the PSBR. It is strongly hoped that the upward revision of the government spending plan for the period up to 1989/90 does not undermine the basic strategy of reducing the PSBR in the medium term. Whether there is scope for an immediate reduction in direct taxes, which in itself is desirable, should be examined in this context.

As for monetary policy, the ongoing financial deregulation and innovation have made it difficult to interpret properly the behavior of monetary aggregates. The authorities are trying to use various supplemental indicators and have attached relatively more importance to the exchange rate and M0. I think that this stance is broadly appropriate. In addition, in the coming months, particular attention needs to be paid in the conduct of monetary policy to any sign of overheating of the economy and of deterioration in the external balances.

Finally, I welcome the authorities' strong efforts toward efficient supervision of financial institutions and coordination of supervisory policies across national boundaries. These are important initiatives to maintain and strengthen the efficiency and stability of the international financial system in the face of rapid financial innovation and globalization.

Mr. Salehkhou made the following statement:

The United Kingdom's economic and financial performance continued to be satisfactory in 1986, and the prospects for 1987 are encouraging. In 1986, the sixth year of real economic expansion, non-oil output compensated for the difficulties in the oil sector, private consumption held total domestic demand relatively high, and further progress was achieved in containing inflation and implementing the authorities' Medium-Term Financial Strategy.

In view of the sharp decline in oil prices in 1986 and the sluggish economic growth in most large industrial countries and in the United Kingdom's traditional developing country markets, such performance was satisfactory, even though imbalances within the economy and differences with the overall performance of its EC and Group of Five partners continued to be a matter of concern. Unemployment in particular remained on the high side in spite of the decline recorded in 1986. Higher inflation and pressures on the exchange rate have also necessitated the maintenance of high nominal interest rates in the face of relatively subdued business investment. Moreover, public expenditure overruns, largely due to independent local authorities, raise doubts about the attainability of the Government's medium-term fiscal targets and reduce the scope for the additional tax cuts needed to align the United Kingdom's tax burden with that of its major trading partners.

The continuation of an unemployment rate above 11 percent after six years of economic expansion suggests major structural transformations in the economy, particularly in view of the steady and strong increases in wage earnings. The increasing number of long-term unemployed and their progressive marginalization as a potential source of manpower appear to be major concerns in this regard. While there seems to be no easy solution to this problem, I agree with the staff that attempts to reduce unemployment through demand-management policies would not only risk rekindling inflation--an area where U.K. performance is below that of its major partners--but could also complicate efforts to contain the fiscal deficit and stabilize the ratio of public debt to GDP. The authorities appear to largely share the staff's view and would appropriately continue to focus their efforts on the need to make labor markets more flexible and on providing the long-term unemployed with training facilities and work programs, including the promotion of profit-sharing schemes. I have long been an advocate of these schemes and am heartened by the recognition that the staff is now accepting them as a viable alternative to traditional wage policies. The cost of these work programs to the budget should, however, be closely monitored so as to limit their impact on fiscal consolidation efforts.

In spite of continued difficulties in interpreting monetary aggregates, mostly owing to ongoing changes in the financial system, and in spite of concerns about the rapid expansion of domestic credit and the massive buildup of liquidity in the economy, monetary policy has continued to be adequate. Depreciation of the real effective exchange rate to reflect the sharp decline in oil prices and to strengthen external competitiveness was achieved in a relatively orderly fashion, although the monetary authorities' task has been complicated over the last year by market disruptions caused by the realignment of the exchange value of the U.S. dollar. While there seems to be some disagreement between the staff and the authorities about the extent to which the current exchange rate has absorbed the effects of lower oil prices, recent developments in oil markets would in principle lessen the staff's concerns. With regard to the United Kingdom's possible membership in the EMS, while such membership would strengthen the credibility of the authorities' nonaccommodation policies, its long-term success would obviously depend on their ability to better align the economy's performance with that of their European partners.

On fiscal policy, North Sea oil revenues and the program of sales of public assets have obviously been instrumental in reducing the public sector's borrowing requirement and somewhat alleviating the economy's tax burden since 1980, even though spending cuts have also contributed to that outcome. The temporary nature of those factors, however, as well as the still high level of the PSBR adjusted for oil and privatization, difficulties in controlling local government and some other expenditures, and the fact that personal tax rates remain high compared with those of other Group of Five countries all point to the need for more ambitious fiscal targets. As indicated by the staff, such initiative would go a long way in compensating for the decline in private savings and containing the pressure on interest rates.

With respect to trade, while the authorities' concern about growing protectionist pressures in the United States unfortunately appears to be well founded, it is also necessary to stress the extensive restrictions maintained by the United Kingdom as a member of the European Community. The effect of these restrictions on developing countries' exports are particularly strong and their scope was further extended by the entry into the EC of two additional members in 1986. In addition to the excessive burden on national budgets and economies, EC protectionist practices are delaying the structural adjustment of members' productive base. They are also damaging the prospects for international trade expansion as they fuel protectionist pressures in other major economies and complicate developing countries' efforts to grow. In this connection, I notice the conspicuous absence of a representative from the Exchange and Trade Relations Department in the staff mission to the United Kingdom as well as in consultation missions to other industrial countries. In view of the impact of the trade policies of these countries in general, such representation as a regular feature of Article IV consultation missions would enhance the treatment of trade issues in staff reports.

Finally, while the decline in the United Kingdom's official development assistance in real terms was reversed in 1986, it should be noted that--at 0.34 percent of GDP--it remains significantly below the United Nations' target as well as that of many smaller industrial countries.

Mr. Mawakani made the following statement:

The supplement to the staff report and Mr. Lankester's statement indicate that overall the economy of the United Kingdom has performed well in 1986 despite recent developments in the oil market. Since I am in general agreement with the staff appraisal, I shall limit my comments to the labor market, the fiscal sector, and the exchange rate.

The relatively high level of unemployment continues to be the most disappointing aspect of U.K. economic performance. Indeed, it is worrisome that although a number of steps have been taken to improve the functioning of the labor market and to address the unemployment situation, the problem remains serious. At about 11 percent of the labor force, the unemployment rate is among the highest in the European Community. The unemployment problem in the United Kingdom appears to be basically structural and seems to require a combination of short-term measures with immediate effects on demand for labor and long-lasting measures to remove rigidities in the labor market. I therefore support the authorities' strategy aimed at dealing with the specific problem of long-term unemployment through training facilities and work programs. Furthermore, the series of measures already in place, including a national decentralized wage policy, and the various employment schemes for the young and the long-term unemployed seem to be in the right direction. In the same vein, I would urge the authorities to pursue their efforts aimed at further deregulating private sector activity and fostering greater differentiation of pay settlements. By removing, or at least reducing, the present rigidities in the labor market, an important step will undoubtedly be made toward increasing the competitiveness of the economy and thus increasing economic growth, which could lead to higher employment.

I recognize that one should be careful when suggesting solutions to the unemployment problem in the United Kingdom because of peculiar developments in its labor market. As Mr. Lankester has noted, the persistence of relatively large pay increases in the face of high unemployment is somewhat puzzling. Another puzzle is the behavior of the unemployment and vacancy curves in Chart 7 of the staff report. While I note the use of different scales in this chart, I would appreciate the staff's explanations for the unusual behavior of these two curves in 1986.

As to the fiscal sector, it is encouraging to note from the supplement to the staff report that recent developments are more positive. Indeed, based on information for the first ten months of 1986/87, the PSBR is expected to be substantially lower than forecast earlier. I therefore support the staff's recommendations that the authorities should adopt a more ambitious target for 1987/88. It is true that progress has been made in the past few years in reducing the PSBR/GNP ratio. However, in view of recent developments, I would appreciate further comments from Mr. Lankester on his authorities' intentions regarding the 1987/88 budget.

On exchange rate policy, in view of the importance of the pound sterling as a reserve currency and the improved competitiveness of the United Kingdom vis-à-vis the EMS countries, it would seem appropriate if the authorities were to accelerate the process of joining the EMS. This would be an important move in the direction of helping to strengthen the EMS and eventually to stabilize the international monetary system.

Finally, it is regrettable that U.K. official development assistance, at 0.34 percent of GNP, still remains far below the UN target of 0.7 percent. However, I note the high degree of concessionality of this aid and its high concentration on the poorest countries. Nonetheless, an effort to increase ODA as a percentage of GNP will be much appreciated.

Mr. Posthumus remarked that he supported the staff appraisal, with a few reservations. He particularly agreed with the staff regarding fiscal policy and the need for a more ambitious PSBR target in 1987/88.

On monetary policy, he shared the concern generally expressed by previous speakers on the monetary situation, Mr. Posthumus continued. In his view, the staff conclusion that there was not much scope for a relaxation of domestic monetary conditions pointed in the wrong direction.

On exchange rate policy, the staff appraisal was not clear, Mr. Posthumus considered. The staff had indicated that the appreciation of the exchange rate should be resisted, and it had also questioned whether a real effective depreciation could be achieved without a change in the nominal effective exchange rate. More fundamentally, the staff had maintained that it was necessary for the United Kingdom to bring the rate of increase in unit labor costs more in line with that of its main trade partners. In that respect, he agreed with the staff. Overall, the staff's comments gave the impression that it would advise the authorities to follow a flexible exchange rate policy.

It was noteworthy that in the past few months a number of staff reports on consultations with member countries had advised the authorities to follow a flexible exchange rate policy, Mr. Posthumus commented. It was possible that flexibility in policies was always good advice, but not every country could carry out a flexible exchange rate policy at the same time. Thus, there might be a problem of consistency among various staff recommendations. In that connection, the communiqué of the Group of Six gave the impression that not everyone would be following a flexible exchange rate policy in the period ahead.

Finally, he supported the remarks made by Mr. Kafka and Mr. Mawakani regarding the level of the U.K. official development assistance, which perhaps could be increased somewhat in the future, Mr. Posthumus remarked.

Mr. Nimatallah made the following statement:

I am in general agreement with the staff's assessments and conclusions. I have only a few comments. My impression of recent economic developments in the United Kingdom is that the economy is basically on the right track. Prospects are good for a seventh year of economic expansion in 1987. The overall expansion has been very good by historical standards. Associated with this expansion has been a steady improvement in the efficiency of the economy owing to the implementation of a number of structural measures and the pursuit of policies favoring competition, such as privatization. Evidence of improving economic efficiency can be seen in productivity gains. For example, recent growth in manufacturing output per capita was as high as 4.5 percent on an annual basis.

As economic imbalances are of both a structural and a macroeconomic nature, supply-side policies have been supplemented by demand-management policies. I am impressed by the ongoing effort to reduce the PSBR. The slow, but steady, reduction in the borrowing requirement has been appropriate; the pace has been gradual enough to allow for the also gradual expansion in private sector activity, and has, therefore, been consistent with maintaining an adequate level of aggregate demand.

This cautious approach to fiscal policy has been reinforced by a monetary policy stance that has facilitated efforts at reducing and controlling inflation. In this connection, I would like to reiterate on this occasion my view that the focus of the U.K. authorities on controlling nominal variables is correct. It has been proven during the years of high inflation that insistence on attaining real growth targets was the main reason behind the perpetuation of inflationary pressures.

In sum, I commend the authorities on the good management of their economy. I only hope that they stay the course and keep up the good work. However, there is that nagging, major weakness: the behavior of wages and the related rigidities in the labor market. It is clear that wage increases should be in line with productivity gains. But over the past years, employers in the United Kingdom have preferred to offer higher real wages to the already employed, because of the high cost of hiring and firing--a practice that implies continued high rates of unemployment. I am not so much concerned about unemployment per se: a relatively higher rate of unemployment is a natural phenomenon of modern times. Rather, I am concerned with the potential loss of competitiveness and efficiency by the U.K. economy.

There is no doubt that the problem of high real wages and related rigidities in the labor market is a structural one, and, therefore, requires persistent structural policies, and not only aggregate demand manipulations. The authorities are aware of this, and, in fact, they have been implementing a range of structural measures in recent years. However, they face aggressive labor unions whose objective is the redistribution of income more in favor of labor. Unfortunately, the end result is a redistribution of the labor share itself in favor of the employed, leading to more unemployment, and, therefore, a loss of efficiency and competitiveness. Perhaps that is why structural measures are taking so long to bear fruit. The authorities and the unions should work together to implement structural measures, particularly to enhance labor mobility and facilitate hiring and firing.

Mr. Zecchini made the following statement:

In 1986 the United Kingdom's economy experienced a further decline of inflation together with a continuation of the expansion of economic activity. The public sector borrowing requirement, after adjustment for temporary revenues and proceeds, was also reduced as a percentage of GDP. These positive results have been brought about by the consistent implementation in recent years of a strategy aimed at improving the supply performance of the economy. However, some of the problematic imbalances that have characterized the economy in the 1980s still persist. Unemployment was reduced marginally and remained at relatively high levels. Labor costs continued to rise both in nominal and real terms, while labor productivity gains decelerated and unit labor costs accelerated further.

As we generally agree with the thrust of the staff's appraisal, we will focus our comments on a few issues which deal with some basic prerequisites for a sustainable growth of the economy over the medium term. These issues concern the performance of employment and of labor costs, and the need to enhance fixed investment, to strengthen the manufacturing sectors, and to maintain external competitiveness.

Fiscal policy should continue to aim at reducing the PSBR as a percentage of GDP to the level that would stabilize the debt/GDP ratio in order to alleviate pressure on interest rates and on the tax burden. Consequently, we believe that little room is left for an expansionary fiscal policy stance aimed at relieving unemployment. However, a better structuring of the expenditure and the revenue sides of the budget can help to expand labor demand by improving the supply side of the economy.

Efforts should be made to reduce the personal income tax burden, as in last year's budget. In this respect, the authorities could take advantage of the additional revenues that might become available through a continued buoyancy of non-oil revenues or through a possible rebound of oil prices above the $15 per barrel forecast. Priority should be given to public programs supporting investment in infrastructure, especially in view of both the declining trend in capital expenditures of the public sector and the overall sluggishness of fixed domestic investment. We therefore commend the authorities for providing extra expenditures of some $1 billion in the 1987/88 budget for housing, schools, and roads, which should boost capital expenditure by more than 6 percent.

As for monetary policy, we welcome the continued flexible use of monetary targeting and the authorities' increasing use of the exchange rate as an indicator of underlying financial conditions. Incidentally, we hope that the authorities will recognize the useful role of the exchange rate also in the context of our discussions on indicators for multilateral surveillance. We tend to agree with the authorities' view that the overshooting of their M3 targets should not be viewed as impairing the objective of controlling inflation. Some signs of a buildup of tension in the price level might, however, exist in spite of the substantial decline of the overall inflation rate owing to the reduction of fuel and raw material prices. The underlying rate of inflation, if measured by the evolution of unit labor costs, seems to have increased recently. Furthermore, a rapid rise in house prices has occurred in the last year, which has often been an early signal of accelerating inflation.

Developments in the labor market call for structural measures rather than for stimuli to demand expansion. Actually, the non-accelerating inflation rate of unemployment is now close to the actual unemployment rate. Among the causes of the increase in the NAIRU, the staff correctly indicates the composition of unemployment characterized by a large share of long-term unemployment. An additional explanatory factor can be identified in the prolonged slack in capital formation in the manufacturing sector. The slow growth of net capital stock might induce a widening of excess supply of labor as long as output approaches peak levels of capacity in the manufacturing sectors. Furthermore, new real wage rigidities in certain segments of the labor force may also have contributed to a rise in the natural rate of unemployment.

In light of these considerations, we welcome the authorities' measures for improving labor market flexibility and the adoption of new vocational training programs. Moreover, there is a need to enhance the housing market conditions through specific actions in regions experiencing labor shortages and through the reform of the rent control system, which is a severely distortive factor. The authorities should also persist in their attempt to enlarge the use of profit-sharing schemes in spite of the lukewarm response of both employers and unions.

In spite of the arguments presented by the authorities, we have some difficulty in sharing their view on incomes policy. The rigidity exhibited by wage settlements--broadly stable around a 6 percent increase from 1984 through the first half of 1986--and the overall lagged response to changes in inflation point to the need to create a better climate for industrial relations and collective wage negotiations. A better understanding of the links between wages and salaries, productivity and employment within an incomes policy framework might greatly contribute to the attainment of the objective of reducing unit labor costs, thereby improving external competitiveness.

On the external account, we note the continued deterioration of the non-oil trade balance, which is forecast to continue in 1987. The deterioration is due to the slow growth of exports coupled with an increasing growth of import volumes. Looking at the composition of import volumes, in the last few years imports of capital goods have been growing relatively less than other consumer items. Such a trend may be the reflection of the sluggishness of capital formation in recent years, and if it continues, might signal negative implications for the long-run sustainability of the current account deficit.

While we commend the commitment to a nonaccommodating exchange rate policy aimed at exerting some pressure on firms for structural improvements in efficiency, we would also recommend that enough downward flexibility for the exchange rate be maintained in the medium term, given current trends in relative costs and prices in the United Kingdom. This would benefit particularly the manufacturing sector and exports. As for export performance, the background paper provides ample evidence of the long-lasting deterioration of the relative position of the United Kingdom in world markets. In our opinion, competitive factors by themselves cannot fully explain such a long-term trend in exports. To improve this trend, it will be necessary to address structural issues, such as the geographical composition and the technology contents of U.K. exports, or, broadly speaking, the nonprice factors of competitiveness. Strengthening trade performance also seems advisable in order not to rely solely on the service balances to improve the current account, which would lead to a rather unbalanced pattern in the balance of payments.

Finally, we commend the authorities' intention to join the exchange rate agreement among EMS member countries in due time. Several favorable developments have now materialized that should facilitate U.K. participation, namely the recent gain in competitiveness, the bottoming out of the oil price fall, and the increasing stock of official reserves. Participation in the exchange rate agreement can also contribute to wage and price discipline, and to reducing exchange rate variability. To these specific advantages, we would add, from a European point of view, the benefits deriving from a deeper economic and monetary integration in the EC.

Mr. Sengupta made the following statement:

I agree with Mr. Lankester that the 1986 economic outturn in the United Kingdom was "quite favorable." That the United Kindgom has secured a positive rate of growth successively in the years since 1981 also makes the situation somewhat unique. However, on examination, developments in 1986 exhibit a number of features with wide implications.

The growth rate of GDP, estimated at 2.3 percent in 1986, is lower than had been estimated earlier, and lower than the annual growth rates achieved in the previous 4-5 years. The rate of increase in private consumption in 1986 was higher than in any of the previous four years. The personal savings ratio dropped to 10.7 percent--the lowest level since 1982. Gross domestic fixed capital formation increased at a much lower rate in 1986 than in any of the preceding four years. In particular, private investment in other than main residential construction showed a decline. Output in the manufacturing sector declined in 1986, for the first time since 1981. It also appears that imports of manufactures, especially of consumer goods, have surged in 1986. The number of firms reporting capacity as a constraint on output has returned to its 1979 level. The increase in capacity strains in 1985 and 1986 show that private investment needs to be raised, especially in the manufacturing sector.

The efficient expansion of the manufacturing sector could also be constrained if the current momentum in unit labor costs continues in the future. The growth rates in both real wages and unit labor costs have been higher than those in other Group of Five countries. After a decade of low growth, productivity picked up significantly between 1981 and 1983. Since 1983, however, there has been a deceleration in the growth of productivity as measured by output per hour. Although profitability has improved, its effect was constrained by the rise in real costs of capital. According to Appendix VI of the supplementary background paper, the current levels of profitability may not be sufficient to enable an adequate and sustainable growth of the capital stock to take place. I would be interested to hear Mr. Lankester's comment on this particular point.

An important feature that emerges from the staff report as well as Mr. Lankester's statement is labor market developments. The persistence of high wage inflation along with high levels of unemployment is not really a "great puzzle" considering the nature of the trade union movement in the United Kingdom. The strength of that movement should be applauded, and no government should ignore the real situation. But Mr. Lankester's explanations are also relevant, especially "the costs involved in hiring and training new workers." It is also true that partly because of the high proportion of the long-term unemployed in total unemployment, there is a structural rigidity in the labor markets and the equilibrating tendencies toward a long-term natural rate of unemployment have weakened.

The authorities do not favor an incomes policy, as they believe that such a policy would not be consistent with the goals of deregulating private sector activity and fostering greater differentiation of pay settlements. Given the realities of the labor market and the rising trend in unit labor costs, I am not sure whether such a stance toward incomes policy would be helpful. This is a point on which the staff or Mr. Lankester may wish to comment.

On exchange rate policy, I find a difference in emphasis between the staff and the authorities. The fall in oil prices has adversely affected the trade balance and government revenues. It also contributed to the effective depreciation of the pound sterling by 10 percent in real terms between the second half of 1985 and 1986. The staff feels that the extent of the depreciation of the real effective exchange rate may not be sufficient, considering the need to maintain competitiveness, control the rates of increase in unit labor costs, and enhance the rate of private investment. These are indeed important considerations that suggest a need for flexibility in exchange rate management, even if there should be a surge in oil prices and inflows of capital in the coming months on account of higher real interest rate differentials vis-à-vis Germany or the United States.

The Medium-Term Financial Strategy is useful for providing the main framework for macroeconomic policy, notwithstanding the frequent revisions and overshooting of the monetary and fiscal targets. The conduct of monetary policy has become very difficult. The velocity of broad money aggregates has declined sharply in the last two years; this is attributed to financial innovation, continued reintermediation after the removal of quantitative restrictions on bank credit in 1980, lower inflation, and positive real interest rates. The pace of domestic credit expansion was very rapid. To contain credit growth, nominal and real interest rates are maintained at high levels. The authorities also maintain monetary targets, which have also been overshot. I am not sure how long, unpredictable, and durable are the effects of financial innovations on the income velocity of broad money. Is it worthwhile to have targets for only the narrow aggregate, M0, when there seems to be a stable relationship between M0 and nominal income that responds predictably to changes in short-term interest rates?

On fiscal policy matters, the staff appraisal has been duly recognized by Mr. Lankester. I have little to add to what has been stated by other Directors. A general point, however, may be raised with a view to improving our understanding of the latest fiscal developments and assessments. The budget will be presented in about three weeks. It would have been perhaps more worthwhile to discuss the report on the U.K. consultation a few days after the presentation of the budget.

As to trade policy and official development assistance, we continue to be concerned about the continued high level of non-trade barriers to imports into the United Kingdom. I am pleased to see that ODA disbursements in relation to GNP rose sharply in 1985. However, the ODA/GNP ratio is below the DAC average of 0.35 percent. I strongly urge the authorities to make efforts to raise this ratio over time to reach the UN target of 0.7 percent of GNP.

Mr. de Groote made the following statement:

The present consultation is an interesting one because the United Kingdom was the first country to put the monetarist approach into practice. The required decisions were often unpopular, and only a strong leader could carry through the prescribed course of treatment in the face of growing popular pressure. Today we are able to judge that the necessary and painful medicine has been effective: the patient is nearly cured. Among the numerous features of this course of treatment I would like to emphasize the success of the privatization of state enterprises. A particularly novel idea at the time it was embraced by the United Kingdom, it has since been copied by many other countries, sometimes with less success.

This silver lining is not without its cloud, however. For example, per capita income is still significantly lower than in other Group of Five countries. Growth performance has been better than average during the last year. Externally, the contraction of the manufacturing sector has been an unavoidable consequence of the decision to let the exchange rate appreciate as a result of the oil surplus. On that point we were right to emphasize during previous consultations that it would have been preferable to put part of the oil income into offshore accounts. It might be argued that the contraction of the manufacturing sector is hardly unusual for an industrial country. We find it, however, particularly worrisome that the sharply deteriorating trend in the non-oil trade balance is only partly offset by a rising trend in the invisible balance's surplus. The contrary is observed in most of the other industrial countries.

As the staff correctly points out, business investment has slowed, and since the government deficit has not increased, the only explanation for the structural deterioration in the balance of payments is the present consumption boom. Chart 2 of the background paper shows that real personal consumption is higher than real disposable personal income. Under these conditions it is questionable whether higher interest rates can have the desired result of discouraging consumption without inducing a slowdown in the rest of the economy; would it not be a better approach to place ceilings on the volume of commercial banks' consumer credit?

The authorities argue that they expect some relief on the trade balance from a recovery of non-oil exports. We are inclined, however, to share the more subdued view of the staff because it seems to us that the recent sharp decline in the U.S. dollar will more than offset the decline in the pound sterling and give dollar-zone exporters a comparative advantage, while the rapid rise of real wages in the United Kingdom threatens to wipe out the competitive gains in the EC linked to the decline of the pound sterling. In any case, it could be argued that the pound sterling was overvalued at the beginning of the 1980s.

With respect to public finances, we agree with the staff that a lower deficit would reassure financial markets, relieve pressure on interest rates, and help sustain investment activity. This is more true because there has been no real improvement in the relative general government financial balance since 1981, as shown in Table 1 of the staff report. The staff also makes a case for revenue-neutral tax reform and advises a reduction in the PSBR target to allow for cyclical and asset-sale effects. We agree with these recommendations because a tax reform permanently reducing tax income seems likely to create future financing problems if based on an income level temporarily boosted by a cyclic peak. In the long run, however, a revenue-reducing tax reform remains a useful target. Such a reform would be in line with Mrs. Thatcher's ideas on the subject, and might be a defendable policy option for the next conservative Government.

As to exchange rate policy, it remains our view that the United Kingdom has not fully benefitted from the monetary discipline imposed by the EMS upon its members. In this regard, the recently issued IMF Working Paper (WP/87/6, 2/17/87) by Jacques Melitz on "Monetary Discipline, Germany, and the European Monetary System" is of great relevance. Given the present exchange value of the pound sterling, the U.K. authorities should give careful consideration to possible EMS membership, which would ensure full participation in the European Community. Though it can be argued that the divergences among the basic economic indicators in the main EC countries are still too large, there is no doubt that these countries' participation in the EMS has resulted in an alignment of policies that would have been unthinkable a few years ago: small adjustments of the central rate have corrected policy divergences and, at times, have offset the kind of speculative capital movements that the United Kingdom considers as an obstacle to the adoption of a more stable rate. Membership of the EMS would provide the U.K. authorities with support from the social partners on difficult issues such as restraint of wages and government expenditures. The discipline imposed by the EMS would thus encourage the authorities to bring the United Kingdom's general financial balance and monetary expansion into closer alignment with that of other EC members, and would exert an additional beneficial effect on the high nominal and real interest rates.

Interest rates in the United Kingdom are high compared with those of other industrial countries. However, present conditions do not allow much room for lowering interest rates because to do so would depress the private savings rate even further, thereby exacerbating inflationary pressures. With MO having reached the top of its target range in the months since the Fund staff visit, both narrow and broad monetary aggregates now seem to indicate some buildup of inflationary pressures. This picture is additionally confirmed by recent OECD statistics showing that consumer price increases accelerated in the final quarter of 1986.

As to unemployment, there is no denying that government policies have given disappointing results. It is also clear that the unemployment of the 1980s is quite different from that of the 1930s. Today, rising unemployment is, paradoxically, accompanied by rapidly increasing real wages. An additional complexity is the emergence of a shortage of skilled labor in certain areas. The staff's attempt to explain these phenomena by means of a distinction between short- and long-term unemployment is quite interesting, and applies to other countries as well. Additional factors may include an excessive strength of the labor unions, which has made the hiring of new workers very expensive. It might be helpful if the Central Government tried to keep wage settlement increases in the public sector below the average for the private sector, in order to dampen the demonstration effect of high public sector wage increases. We also wonder whether the planned tax reduction may not assist a moderation in wage demands.

According to press reports, the United Kingdom is coming closer to the acceptance of more stable exchange rates by means of an arrangement with other large industrial countries. I would be happy if the need for more stable exchange rate relationships with the United States and Japan could bring the U.K. authorities closer to admitting that membership in the EMS would certainly enhance chances of making the Group of Five agreement more effective as far as the United Kingdom is concerned. The notion that the size of capital movements in and out of the United Kingdom is such that they would make participation in the EMS difficult would certainly have to be re-examined in view of the magnitude of the capital flows that can occur between the United Kingdom and the United States. Let us hope that the Group of Five agreement will thus, paradoxically, bring the United Kingdom closer to the Continent.

Mr. Dai made the following statement:

The U.K. authorities should be commended for a sixth successive year of economic expansion, although the pace in 1986 was somewhat slower. According to the staff, a seventh year of expansion is also in sight. Moreover, the achievements of 1986 were recorded at a time when slower economic activity was evident in most of the OECD countries, and the fall in oil prices caused a $4 billion reduction in the United Kingdom's net oil exports and a further deterioration in its terms of trade. Much progress has been made to reduce the PSBR to its lowest level in relation to GDP since the early 1970s and to keep the current account in balance, although, after registering a surplus for several years, the current account is projected to show a deficit over the next few years. However, given the huge buildup in overseas assets in recent years, which will certainly provide a comfortable cushion, I tend to agree with Mr. Lankester that "this should not be a major cause of concern."

As I am in broad agreement with the staff appraisal that the Government's strategy over the past six years has been broadly successful, I shall comment on only a few points.

Unemployment, which has remained at high levels for a long time, must be cause for concern. Although the rate has at last begun to drop, the present level of 11 percent is still too high. The Government has implemented a number of major reforms aimed at reducing unemployment; unfortunately even with these reforms and even with the detailed explanations given by Mr. Lankester, the stubbornness of this problem and the various difficulties associated with dealing with it strongly suggest that additional measures and structural reforms are needed. I am encouraged by the steps already taken by the Government and by the knowledge that the authorities are prepared to take additional measures to help the long-term unemployed, such as the yearly interview system, the encouragment of regional pay variations, and the creation of new jobs in service industries. I hope there will be steady progress in the coming year; I am, however, very much aware that the United Kingdom's unemployment problem cannot be eliminated within a short period of time in view of its structural nature.

As for wages, competitiveness, and efficiency, I believe wages and salaries in the United Kingdom are still increasing too fast. The growth of average earnings has remained at 7 1/2 percent for the last three years, and real wages have risen at a rate of 3-3 1/2 percent. I wonder what kind of adverse effect these factors have had on the competitiveness of U.K. products. Mr. Lankester has pointed out that the Government's longer-term task is to improve the efficiency of the economy and that the authorities "are now seeing the fruits of a major improvement in the efficiency and organization of production." These developments, I hope, will offset somewhat the adverse impact of the unemployment rate and, in turn, help to reduce it.

Oil revenues have contributed much to the current account balance over the past several years. Though the implication of the evolution of oil prices for the economy should not be exaggerated, the importance of the decline in the manufacturing sector also cannot be underestimated, and it certainly deserves the authorities' attention. I am pleased to hear that non-oil output, particularly in recent months, has been growing faster than it had previously.

Finally, it is encouraging that the economy has been growing and expanding, and I hope that the U.K. Government will soon find itself able to increase its official development assistance.

Mr. Lundstrom made the following statement:

Since I am in broad agreement with the analysis and conclusions of the staff, I shall comment only on a few main issues. If these comments are mainly of a critical nature, it does not mean that I do not recognize the significant accomplishments of the U.K. economy over the last few years. Thus, I concur with the staff that the U.K. strategy of reducing inflation and raising the rate of growth of real output has been broadly successful. The growth of real output during the last five years has been generally satisfactory, although it has not been markedly better than growth in other major industrial countries. The rate of inflation has been reduced substantially since 1981, but it is still higher than in many other countries; and there are now indications that the gap is widening.

Inflation thus remains an important problem, and it is also the main reason for the high interest rates, which are in themselves a problem. The relatively high inflation rate is mainly due to the fact that wages and unit labor costs have been rising more rapidly in the United Kingdom than in the other industrial countries. Thus, despite the high rate of unemployment, nominal wage earnings have risen at an underlying annual rate of 7 1/2 percent over the past three years, implying sizable gains in real wages. The combination of a rate of unemployment of 11-12 percent and strong wage increases is probably the most important and challenging problem in the U.K. economy. It suggests--according to the staff--that the nonaccelerating inflation rate of unemployment is close to the actual rate of unemployment, and that any attempt to reduce unemployment through demand management would risk rekindling inflation. This situation is indeed surprising, and the staff's explanations for it do not make it less alarming. Nor does Mr. Lankester's observation that a number of important labor market reforms have already been implemented. The staff argues, however, that it would be hazardous to look to demand expansion to reduce unemployment.

It is, however, quite possible that the nonaccelerating inflation rate of unemployment tends to increase with actual unemployment, and problems may thus be aggravated if policies are too restrictive. A modest demand expansion such as the Government envisages for this year appears to be possible without any serious inflationary risks. At the same time it is necessary to tackle the unemployment problem with policies aimed at improving the functioning of the labor market. Temporary relief has to be provided through employment schemes. A number of such schemes, some of considerable scope, are already in operation. A number of measures have also been taken over recent years to improve the functioning of the labor market, but their effect has so far been surprisingly small. These efforts should be continued; if persevered with, they could have a significant effect on industrial expansion and on structural change, which are both necessary to restore the industrial base and competitiveness in the long run.

With regard to fiscal policy, the curtailment of the PSBR has been a main fiscal policy goal in recent years, and the actual PSBR has been substantially reduced in the last five years. Spending plans for the period to 1989/90, which originally provided for no change in general government expenditure in real terms, have lately been revised upward. However, the increase in government expenditure over the next three fiscal years is expected to be substantially lower than the growth of GDP. Accordingly, even with some tax reductions and smaller receipts from the oil sector, the PSBR as a percentage of GDP may continue to decline.

On exchange rate policy, we are in broad agreement with the staff's assessment, although I agree with the point made by Mr. Posthumus on flexibility. In this connection, the need for the United Kingdom to bring the rate of increase in unit labor costs in line with that of its main trade partners can hardly be overemphasized, irrespective of what is eventually decided with regard to the EMS. Of course, it would be interesting to hear if Mr. Lankester has any comments on Mr. de Groote's remark on the EMS in relation to the greater currency stability announced recently by the Group of Six.

Monetary policy has been pursued with some flexibility, in spite of the difficulties of interpreting changes in monetary aggregates because of changes in financial markets. When pressure on interest rates has been strong, the pound has been allowed to depreciate, and vice versa. We welcome the authorities' recent statement that they will resist any further depreciation and the reaffirmation of their commitment to a nonaccommodating exchange rate policy.

Finally, my authorities note with some satisfaction that the negative trend in development aid has been reversed, but the ODA/GDP ratio is still, and will for many years remain, at a comparatively low level.

Ms. Bush made the following statement:

We strongly endorse the U.K. authorities' Medium-Term Financial Strategy of containing inflation by slowing the growth of nominal demand, promoting growth by implementing measures aimed at increasing the supply of goods and services, and reducing the scope of the Government's economic activity and its resulting borrowing requirements. This economic strategy, which includes major structural reforms, has been sustained for a number of years, and has paid off in many respects. A good indicator of its success is the continued, fairly steady, growth of the economy.

The economy continued to perform satisfactorily in 1986, despite the slight slowdown in real economic growth. There are some signs indicating recovery in 1987, as a less negative contribution to growth is expected from the external sector and domestic demand is expected to continue to be fairly strong. These developments are taking place, however, in an environment where inflation rates exceed those in other major industrial countries. As charts in the staff report clearly indicate, the faster pace of inflation continues to exert pressures on interest rates and therefore could have contributed to the lackluster performance of investment in 1986. Interestingly, the staff report mentioned that if interest rates are deflated by unit labor costs to determine real interest rates, the cross-national divergence of real interest rates virtually disappears. We would welcome staff comment on which index serves as the best indicator of U.K. competitiveness, taking into account the underlying rate of inflation.

Regarding developments in the labor markets, average wage settlements remain high relative to inflation and to wage adjustments in other industrial countries. The staff report suggests that there might be some degree of tightness in the labor markets. This tightness can be inferred from the higher vacancy rates, juxtaposed with the long-term unemployed and the question of their employability, as well as with the skilled labor shortages. This configuration could be contributing to higher inflation as high wage adjustments are incorporated into the pricing structure. The relationship between the long-run natural rate of unemployment and the existing unemployment rate, which is examined in Appendix V of the background paper, suggests the need for a more concentrated effort on the unemployment problem and a more specific plan than is implied by reliance on demand growth to reduce unemployment. Some measures to reduce the number of long-term unemployed are being implemented, for example, the adjustment of some benefits policies. However, additional, difficult structural measures seem to be necessary to encourage a higher degree of internal labor mobility. Perhaps Mr. Lankester could provide some additional information regarding the likelihood of action on issues related to labor mobility, such as rent control, differentiated regional wage settlements, and tax relief to promote profit sharing. I understand that the authorities are now encouraging wage settlements at the local level rather than the national level; any additional, specific information on these matters would be appreciated.

The illuminating appendix on the labor market raises some interesting issues related to the success of demand stimulus policies in generating reductions in unemployment. It appears that for the United Kingdom, with its high degree of labor market rigidities, the best course for fiscal policy is to exercise expenditure restraint, while avoiding revenue measures that adversely affect incentives to work. Some recent tax reforms and the gradual reduction in the expenditure to GDP ratio are encouraging signs, as is the commitment in the Medium-Term Financial Strategy to further reductions in government expenditures relative to GDP. We were somewhat concerned about the higher expenditures this fiscal year, but with tax revenues buoyant, the PSBR is now expected to be below target. We would nonetheless urge continued economies on expenditures, so that further attention could be given to tax reform aimed at reducing the relatively high personal income tax rates and high payroll taxes, with a view to encouraging the unemployed to seek jobs and employers to hire. A tax reform package that would restore incentives to workers and the productive sectors should be given serious consideration. The staff points out that the buoyancy of tax revenues has partly resulted from the reform of business taxation. Similar positive results could result from a reduction in personal taxes. Like Mr. de Groote, I think this could relieve some wage pressures and perhaps ultimately improve the unemployment situation.

In the area of monetary policy, the recent growth in broad monetary aggregates, could, under some conditions, create concerns regarding inflation. However, the velocity of M3 has dropped, and we noted the authorities' view that M0 serves as a better indicator of the possible buildup of inflationary pressures. The ongoing financial deregulation naturally complicates determination of the relationships between monetary aggregates and economic activity, and it appears that in a difficult, rapidly changing environment, monetary policy has been managed fairly cautiously, although we would urge constant monitoring of all aggregates.

Monetary policy, and in particular, interest rate policies, have also been managed with a view toward exchange market developments. In view of the complications arising from oil price developments, exchange rate policy has followed a prudent course and has resulted in a rate currently reflecting fundamentals. Nonetheless, priority should be given to containing wage pressures so that competitiveness is not eroded, in light of the authorities' view that they do not want to "accommodate" wage increases by automatically adjusting the exchange rate. The large buildup in net foreign assets seems to ease the authorities' concerns over the emergence of current account deficits; it should be noted, however, that a net foreign assets position can change more quickly than might be expected, as the experience of a number of countries over the past few years demonstrates.

Two final issues are privatization and deregulation. The financial deregulation that is under way can assist in maintaining the United Kingdom's important role in international capital markets, and we have fully supported these reforms. It is perhaps too early to see exactly what their long-term effect will be, but the changes that have been implemented go far toward increasing the competitiveness of the U.K. financial sector while improving the international mobility of capital in general. The broader benefits that should accrue to the entire economy are not easily specified, but we think that the more open financial environment can contribute to the promotion of a more competitive industrial sector as well. We also welcome the privatization effort that has been under way, with its aim of strengthening the scope of market incentives and providing a sound base for longer-run growth.

Finally, we endorse the authorities' commitment to resisting protectionism and to promoting further trade liberalization through the new GATT round of trade negotiations. We welcome, in particular, their interest in reforming agricultural policies; we share their view that such an approach is beneficial to all participants and look forward to joint success.

The Executive Directors agreed to continue their discussion in the afternoon.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/87/30 (2/20/87) and EBM/87/31 (2/24/87).

3. VENEZUELA - 1986 MIDYEAR ARTICLE IV CONSULTATION - POSTPONEMENT

Notwithstanding the period of three months specified in Procedure II of the document entitled "Surveillance over Exchange Rate Policies" attached to Decision No. 5392-(77/63), adopted April 29, 1977, the Executive Board agrees to extend the period for completing the 1986 midyear Article IV consultation with Venezuela to not later than March 2, 1987. (EBD/87/49, 2/18/87)

Decision No. 8534-(87/31), adopted
February 20, 1987

4. ASSISTANT TO EXECUTIVE DIRECTOR

The Executive Board approves the appointment of an Assistant to Executive Director as set forth in EBAP/87/31 (2/18/87).

Adopted February 20, 1987

5. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/87/33 (2/20/87) is approved.

APPROVED: September 18, 1987

LEO VAN HOUTVEN
Secretary